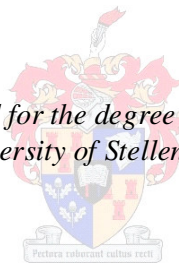


The External Relations of Company Groups in South African Law: A Critical Comparative Analysis

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*Dissertation presented for the degree of Doctor of Law at the
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Declaration

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Summary

Groups of companies are part of the realities of the modern economic system. Despite the fact that such groups often function as a single economic entity, the legal point of departure remains that each company within the group of companies is a separate juristic person. The result of this is that a creditor of a company within the group can, in principle, only enforce his claim against the company which he contracted with or which caused him harm. Should he wish to claim from the holding company or other solvent companies within the group, he would have to rely on an exception to the doctrine of separate juristic personality, *viz* the possibility of piercing the so-called corporate veil. This dissertation is a comparative study of the extent to which the law protects a creditor of an insolvent company within a group. The applicable laws of Australia, Germany, New Zealand, the United Kingdom and the United States of America, were investigated and compared to the South African position. The dissertation concludes that the South African legal treatment of the problem is unsatisfactory and that the law should be amended through appropriate legislation

Opsomming

Maatskappygroepe is realiteite in die moderne ekonomiese wêreld. Ten spyte van die feit dat maatskappygroepe dikwels een ekonomiese entiteit vorm, huldig die reg die standpunt dat elke maatskappy binne 'n groep maatskappye 'n aparte regspersoon is. Die gevolg van hierdie standpunt is dat 'n skuldeiser van 'n maatskappy binne 'n groep in beginsel slegs 'n eis het teen die maatskappy met wie hy gekontrakteer het of wat hom skade berokken het. Indien hy 'n eis teen die houermaatskappy of ander solvente maatskappye binne die groep wil instel, moet hy steun op 'n uitsondering op die leerstuk van aparte regspersoonlikheid, te wete die moontlikheid om die sogenaamde korporatiewe sluier te deurdring. Hierdie proefskrif is 'n regsvergelykende ondersoek van die beskerming van 'n skuldeiser van 'n insolvente maatskappy binne 'n groep. Die toepaslike reg van Australië, Duitsland, Nieu-Seeland, die Verenigde Koninkryk en die Verenigde State van Amerika word ondersoek en vergelyk met die Suid-Afrikaanse regsposisie. Die proefskrif kom tot die gevolgtrekking dat die Suid-Afrikaanse regsreëling onbevredigend is en deur geskikte wetgewing gewysig moet word.

Acknowledgment

This dissertation is for my parents.

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Chapter 1

Introduction

1.1 Background

Bonbright and Means already in 1932 recognised the special status of the holding company and its ability to avoid certain regulatory practices. The authors state that:

“[T]he holding company has become the greatest of the modern devices by which business enterprises may escape the various forms of social control that have been developed, wisely or unwisely, as a means of limiting the vast power of the great captains of industry.”¹

The fact that multinational enterprises control the world economy to a large extent today serves as testimony for the prophetic words of Bonbright and Means and those words are equally valid for today’s globalised economy.

Company groups are commercial realities in the modern globalised world. Not only do they play an important role on the economic stage worldwide, but they also play an important, if not crucial, role on the domestic stage within the borders of countries which embrace a capitalist economic and business system. Even at the level of small business enterprises, including agriculture, entrepreneurs and sophisticated farmers organise their businesses in the form of groups by separating the operating entities from the controlling entities. This is done to reduce the risk to which the entrepreneurs may be exposed should a business venture fail. The operating entity would lease the land, equipment or assets from the controlling entity. Should the business venture fail, the operating entity would be the entity exposed to the risk of failure. Creditors would, however, find that the operating entity is nothing but an empty shell with the assets belonging to the controlling entity.

At the global level company groups are more commonly known as multinational enterprises. This usually means a company which has subsidiary companies all across the globe. There are over 60 000 multinational enterprises in the world according to the most recent statistical data available on the subject in respect of company groups or

¹ Bonbright & Means *The Holding Company, its Public Significance and its Regulation* (1932) 7.

multinational enterprises which could be found.² This data also shows that foreign multinational companies, meaning companies whose holding companies are not incorporated in the United States of America, employed approximately 5.2 million United States citizens in 2003. At the same time American multinational enterprises employed about 8.4 million people worldwide. The quoted Progressive Policy Institute (PPI) article further refers to the United Nations Conference on Trade and Development which published data in 2002 indicating that 29 of the top 100 best performing economies at that stage were multinational enterprises and not countries. The PPI article continues by referring to the proliferation of the number of multinational enterprises from about 7 300 in 1969 to the estimated 63 000 in 2000.

As a further example a study in respect of company groups was conducted in Australia in 1997.³ The study showed that 89% of the listed companies directly or indirectly controlled other companies. In other words they were not necessarily the holding companies of other companies but had the power to control the decision-making in other companies. Similar research could not be found for South Africa. A brief perusal of the top 40 listed companies on the JSE,⁴ however, shows that five of the top twenty listed companies on the basis of market capitalisation have the word “group” in their names.⁵ It is conceivable that the majority, if not all, of the top twenty companies are part of groups of companies.

²*PPI online trade fact of the week* 27 April 2005.

http://www.ppionline.org/ppi_ci.cfm?knlgAreaID=108&subsecID=900003&contentID=253303 (accessed 22 November 2009).

³ The Companies & Securities Advisory Committee *Report on Corporate Groups* (2000) 1 with reference to a study by Ramsay & Stapledon *Corporate Groups in Australia* (Research Report, Centre for Corporate Law and Securities Regulation University of Melbourne 1998).

⁴ Formerly known as the Johannesburg Securities Exchange.

⁵ Data as at 20 November 2009 obtained from the JSE. These companies are MTN Group Ltd, Standard Bank Group Ltd, ABSA Group Ltd, Vodacom Group Ltd and Nedbank Group Ltd.

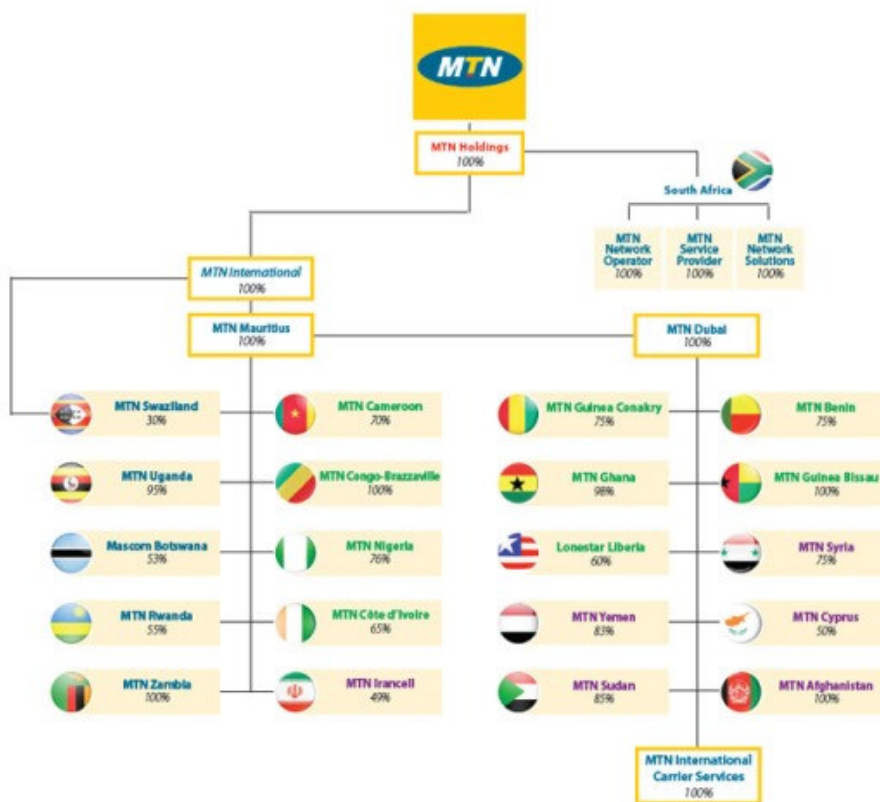


Figure 1: MTN Group Ltd *Integrated Business Report* for the year ending 31 December 2008.⁶

Company groups can be organised in various forms. A group can be organised in a vertical fashion as illustrated by the MTN Group Ltd example⁷ or in a horizontal manner. Within the vertical group structure there is a holding company with a number of subsidiary companies which in turn could have further subsidiary companies as illustrated by the MTN group structure.⁸ Within the horizontal group structure there are no holding and subsidiary companies. Instead companies hold shares across a horizontal line in other companies which in turn also hold shares in the first-mentioned companies.⁹ The Japanese *keiretsu* is an example of a horizontal group where a complex web of interlocking shareholdings exists amongst numerous companies.¹⁰

⁶ MTN Group Ltd *Integrated Business Report* 2008, for example, which is sixth on the top forty listed companies list. http://www.mtn-investor.com/mtn_ar08/ (accessed 24 November 2009).

⁷ MTN Business Report 3.

⁸ MTN Business Report 3.

⁹ Eisenberg "Corporate Groups" in Gillooly (ed) *The Law relating to Corporate Groups* (1993) 1 13.

¹⁰ Dine *The Governance of Corporate Groups* (2000) 39.

Within the vertical company group the ultimate holding company is the directing force or the ultimate decision-maker in respect of the policies of the subsidiaries since it would inevitably have the power to appoint and dismiss the majority of the directors on the boards of the various subsidiary companies. The Companies and Securities Advisory Committee on Corporate Groups in Australia puts certain criteria forward in its synopsis of the integration of groups of companies in order to compare different company groups. It refers to criteria such as economic organisation, market reasons and the public image of the group of companies which distinguish it from other groups of companies. In respect of economic organisation, for example, the question is asked whether employees are rotated among the companies within the group. In respect of marketing the question is asked whether the same trademarks are used across the group and in respect of the public image whether the group is publicly portrayed as a single enterprise.¹¹

This chapter highlights what a group of companies is, why groups of companies are formed, the legal structure of a group, namely a holding company and a subsidiary company in a group of companies' most basic form and the problems associated with groups.

1.2 The reasons for company groups

Bonbright and Means also identified some of the reasons why a group of companies would be formed in the 1930s. They identified four reasons, namely (i) the centralised control of previously independent companies; (ii) to consolidate the financial structure of previously independent companies by the holding company becoming in effect the financier of the subsidiaries under its control;¹² (iii) the recapitalisation of the financial structure of one or more companies by substituting the shares of the holding company for the shares of a subsidiary;¹³ and (iv) to gain voting control of the subsidiary with very little financial investment.¹⁴

¹¹ The Companies & Securities Advisory Committee *Report on Corporate Groups* (2000) 2-3.

¹² Bonbright & Means *The Holding Company* 14.

¹³ See Bonbright & Means *The Holding Company* 15-17 for the example of the Long Island Capital Corporation and Long Island Lighting company.

¹⁴ Bonbright & Means *The Holding Company* 12; 18-20.

The most important reason, however, is probably to reduce the risk to which the holding company is exposed. Risk in this context means the possible legal risk which necessitates the creation of a vertical structure of a holding company and a subsidiary company. The point of departure is that every company within a group structure is a separate juristic person and as such it has its own rights and liabilities. This in turn means that one company in a group structure is not liable for the liabilities of another company within the group structure. In the light of the fact that each of the various entities within a company group structure retains its individual juristic personality, it automatically reduces the commercial risk of the other companies within the group. Subsidiary companies can therefore be incorporated with a minimal share capital to undertake business ventures which could otherwise be too risky for the holding company. Should the venture not be successful the holding company only loses its investment.¹⁵

The creation of subsidiary companies could also lead to a more efficient management system. The larger a single company grows, the more difficult it may become to manage it efficiently. It would make sense to break up the company into smaller legal units with their own management structures to effect a more decentralised management format.¹⁶

It is also possible that a company may create a group structure by taking over another company which conducts business in a related field to increase its market share or to increase the scale of its business. Instead of buying the assets or business of that company it could instead buy the shares of the company. It will therefore gain control over the assets and business of that company including the intellectual property of the target company and the goodwill attached to it.¹⁷

The controlling shareholders of a company may also seek outside investment without wanting to relinquish any shares or their control of that company. The company therefore incorporates a subsidiary company and grants outside investors a minority stake in that

¹⁵ See chapter 2 and chapter 7 below.

¹⁶ See generally the Companies and Securities Advisory Committee *Report on Corporate Groups* 3.

¹⁷ The Companies and Securities Advisory Committee *Report on Corporate Groups* 3.

subsidiary company.¹⁸ Another reason is that a company may want to retain full control over the whole production and supply chain in respect of the products which it produces from the acquisition of the raw materials stage up to the final supply and retail stage to the general public. A company may also want to increase its profits by investing in other companies which are neither directly nor indirectly involved in the existing business sphere of the company. The purpose of this investment is purely financial in nature and not for any other practical or legal reason.

1.3 The legal definition of a group of companies

Prior to the passing of the Companies Act 71 of 2008¹⁹ (the new Companies Act), no statutory definition existed in South Africa of a company group although the legislature attached some consequences to the relationship between holding companies and subsidiary companies. The new Companies Act defines a “group of companies” as “two or more companies that share a holding company or subsidiary relationship.”²⁰

The new Companies Act does attach some consequences to groups of companies²¹ and also defines holding companies and subsidiary companies. A holding company “in relation to a subsidiary, means a juristic person or undertaking that controls that subsidiary.”²²

The new Companies Act defines a subsidiary company, broadly speaking, as a company which is under the control of another juristic person. The control can either be exercised by the juristic person by means of holding the majority of voting rights in the subsidiary company, or the power to control the board of directors by means of the power to appoint

¹⁸ The Companies & Securities Advisory Committee *Report on Corporate Groups* 3.

¹⁹ The new Companies Act was published in Government Gazette No 32121 of 9 April 2009 but has not come into effect yet at the time of writing this dissertation.

²⁰ S 1 of the new Companies Act.

²¹ See chapter 5, para 5.3 below. An example is loans between companies within a group of companies, para 5.3.2 below.

²² S 1 of the new Companies Act.

or elect the directors who control the majority of the voting rights in board of directors' meetings of the subsidiary company.²³

1.4 Problems arising within company groups

“The time is fast coming when the people of the United States will no longer submit to this economic dictatorship by a great privately controlled institution, originally conjured up by legislative act, but now becoming more powerful than the government itself. Useful as the institution is when properly guided and limited, it may be destroyed by an angry electorate if our courts and legislatures do not find a way to make it amenable to the social control to which the activities of individual business men and ordinary corporations are subject. The greatest enemies of the holding company are not the critics who point to its present abuses, but rather those business men who stubbornly resist all efforts to bring it under governmental control and those judges who invoke the notion of separate corporate entities against all attempts to make it responsible for the acts of its subsidiaries.²⁴

This statement dating from 1932 was made in the light of the apparent abuses by holding companies in the public utilities system, namely the railways, the provision of gas for household use and the provision of electricity. The opinion of the time was that by means of holding companies controlling the operating entities, services were sacrificed for profit which landed in the hands of a selected few; the (major) shareholders of the holding company. Very often the holding company was not subject to any regulatory control, unlike the operating company, which led to holding companies charging their subsidiaries management or service fees which impacted on rates which the public had to pay to the operating utility companies, for example for electricity.²⁵ The question is whether the authors' assessment is still correct today.

The problems which are associated with groups of companies can be put into two broad categories. The first category deals with internal problems and the second category concerns the external problems. By internal problems is meant governance problems which may arise within a group of companies. Two such problems are important. In the

²³ S 3(1)(a) of the new Companies Act which will be discussed in greater detail in chapter 5, paras 5.2 and 5.3 below.

²⁴ Bonbright & Means *The Holding Company* 339.

²⁵ For an interesting overview see in general Bonbright & Means *The Holding Company*.

first place there is the problem of fiduciary duties of directors within a group of companies and secondly the position of minority shareholders of companies which form part of the group of companies. In respect of the internal problems, especially the position of minority shareholders the problems are compounded by the common-law principle of *Foss v Harbottle*²⁶ in terms of which the minority shareholders have to submit themselves to the will of the majority except in exceptional cases.

The external problems posed by groups of companies are, firstly, their liability *vis-à-vis* their voluntary and involuntary creditors. Voluntary creditors in this context mean those third parties with whom a company within a group of companies has some form of contractual relationship. Involuntary creditors are those creditors whose relationships with a company within a group of companies arise in an involuntary manner, typically through the delict of a company within a group of companies. The second external problem is the position of creditors of companies within the group when one of the companies, or all of the companies, in a group, is insolvent.

Intra-group debts are also problematic. It is difficult to classify this problem as external or internal. It is external in the light of the fact that there is a contractual relationship between the lender and the borrower but also internal in the light of the fact that governance problems could arise due to the probable absence of an arm's length transaction.

1.4.1 The internal problems

(i) The position of minority shareholders within a company group

The position of minority shareholders and their protection by necessary implication is only relevant where the subsidiary company is not a wholly owned subsidiary company.²⁷ Minority shareholders are always vulnerable in a company. This is particularly the case where they hold less than 25% of the issued shares of a company and are therefore unable

²⁶ *Foss v Harbottle* (1843) 2 Hare 461.

²⁷ For a definition of a wholly owned company refer to section 3(1)(b) of the new Companies Act.

to veto any amendment to the constitution of a company or other particular issues for which legislation requires a special resolution.²⁸

Minority shareholders are also vulnerable in the context of a group of companies. Minority shareholders could refer here to the minority shareholders of the holding company or also to the minority shareholders of the subsidiary company. The holding company may exercise its powers to the detriment of the position of the minority shareholders of the subsidiary company by, for example, authorising the sale of the majority of assets or business or all of the assets or the whole business of the subsidiary company to another company within the group. The holding company may also, in its position as controlling shareholder of the subsidiary or in its position as the shareholder with the power to appoint or dismiss the directors with the majority voting rights at board meetings of the subsidiary company, cause the subsidiary company to declare a dividend at a time where the funds of the subsidiary company could be better utilised for investment purposes for the future growth of the subsidiary company.²⁹ The converse is also possible by retaining funds for group expansion while depriving the minority shareholders of expected dividends. The question therefore arises whether the minority shareholders of companies within a group are adequately protected.

(ii) The fiduciary duties of directors of companies within a group structure

The point of departure is that a director of a company owes a fiduciary duty to the company of which he is a director. Within a group of companies, therefore, a director of, for example the holding company, does not owe a fiduciary duty to the subsidiary company. The question arises whether this should be the position or whether the directors of the holding company should in appropriate circumstances owe a fiduciary duty to the subsidiary company as well. An ancillary question is whether the directors of the holding company should not be allowed to act for the benefit of the group instead of focusing their attention on the benefit of the companies of which they are directors.³⁰

²⁸ A 75% majority in general.

²⁹ The Companies & Securities Advisory Committee *Report on Corporate Groups* 73.

³⁰ The Companies & Securities Advisory Committee *Report on Corporate Groups* 35.

Another problem which needs to be highlighted within groups is the position of the directors of a subsidiary especially where they are appointed solely by the holding company, or, even worse, where the directors of the holding company are also the directors of the subsidiary. This problem is only relevant where there are minority shareholders either in the holding company or in the subsidiary company.

It is trite law that a director of a company has a fiduciary duty towards the company of which he or she is a director. This means that he has to act in the interest of the company and not serve his own interests. In the case of a single company the question is posed more and more whether a director does not owe a fiduciary duty to other interest groups in a company, for example creditors, or regarding broader environmental issues as well.³¹

According to *R v Milne and Erleigh*³² and *Lipschitz and Another NNO v Landmark Consolidated (Pty) Ltd*³³ a director of a company within a group of companies does not owe a fiduciary duty to the group as a whole. The aforementioned cases, furthermore, held that the directors of the parent company should not allow the dominant power of the holding company over its subsidiaries to undermine the subsidiaries from acting in their own interests.³⁴

Apart from the two cases mentioned above no other South African judicial decision in respect of the question of fiduciary duties of directors within the context of a group of companies could be found. However, the new Companies Act provides that a director of a company “must not use the position of director [...] to knowingly cause harm to the company or a subsidiary of the company.”³⁵ What this duty entails is not entirely clear. It will be interesting to see the interpretation of this provision where a director of the holding company acts in the interests of the holding company but the action is to the

³¹ Havenga “Directors’ fiduciary duties under our future company law regime” 1997 9 *SA Merc LJ* 310.

³² *R v Milne and Erleigh* 1951 1 SA 791 (A).

³³ *Lipschitz and Another NNO v Landmark Consolidated (Pty) Ltd* 1979 2 SA 482 (W) 488.

³⁴ See also Van Dorsten *The Law of Company Directors* 2ed (1999) 226.

³⁵ S 76(2)(a)(ii).

detriment of the subsidiary and how a court will reconcile the director's conflicting duties towards the holding company and the subsidiary company.

In *Lindgren and Others v L&P Estates Ltd*³⁶ the Court of Appeal in England rejected the notion that the director of a holding company owes a fiduciary duty to the subsidiary company. The court held that:

“A great number of cases was cited, but I get no benefit from them. It is of course true that a trustee cannot in general deal with himself or get an advantage himself in a transaction in which he is on both sides of the table, and authority is not needed for so well-known a proposition, but Mr. Lindgren was a director not of the defendant company but of the City company. He may have been in breach of his duty to that company but he owed no duty to the defendant company, although it was about to become a subsidiary of the City company. To hold that Mr. Lindgren, a director of the City company, was bound to protect the interests of one of its subsidiaries which had an independent board is to stretch the principle altogether beyond reason.”³⁷

It would appear from the case law at hand that the courts have been consistent in holding that a director of the subsidiary company should act in the interest of the subsidiary company. Furthermore, the directors of the subsidiary company should always exercise their judgment in an unfettered manner. There will, however, be instances where the directors of the subsidiary are under the full control of the holding company, but in that case there is an argument to be made that the holding company, or the directors behind the holding company, have a duty towards the subsidiary company to observe the utmost good faith in dealings with that company as stated in the *Robinson v Randfontein Estates Gold Mining Co Ltd*³⁸ case.

³⁶ *Lindgren and Others v L&P Estates Ltd* [1968] 1 Ch 572; 1968 1 All ER 917 (CA); [1968] 2 WLR 562.

³⁷ 922E-F.

³⁸ *Robinson v Randfontein Estates Gold Mining Co Ltd* 1921 AD 168.

1.4.2 The external problems

(i) The position of creditors of an insolvent company within a company group

The default position is that the creditors of a company have to look to the company for the satisfaction of their claims and not to the shareholders of the company.³⁹ The position is the same where a creditor has contracted with a company which forms part of a group of companies. The question therefore arises whether the (solvent) companies within a group should stand in for the debts of the insolvent companies within a group where those insolvent companies are in liquidation, either by means of a contribution or by means of a pooling of the assets of the companies within the group.⁴⁰

(ii) The position of contractual and delictual creditors of companies within a group structure

A company has creditors which may be contractual or delictual. The contractual creditors are, to a degree, better off than the delictual creditors since they could at least contractually arrange for security where the contracting company is unable to pay its debts. It could, however, happen that their claims will not be satisfied because the contractual debtor company is in liquidation or is unable to pay. This will be discussed under the liquidation of a company within a group structure.⁴¹

Delictual creditors are not in a position to arrange for security for their claims due to the nature of their claims. Delictual creditors of a company within a group did not become creditors of the specific company through choice but involuntarily. It can be that the person is a consumer who bought a product of the subsidiary company and suffered harm, or an employee of a subsidiary company who has suffered harm due to the business activities of the subsidiary company, or a completely innocent third party who was injured by an employee of a subsidiary company while that employee acted in the course of his duties. The question arises whether the person who has suffered loss in the above

³⁹ *Salomon v Salomon* [1897] AC 22 [HL].

⁴⁰ Chapter 7 below.

⁴¹ Chapter 7 below.

circumstances can recover his loss from the holding company or any other subsidiary company within the group structure.

1.5 The problem of limited liability

The problems mentioned in 1.4 can all be traced to the doctrine of limited liability. A historical perspective is necessary to understand the current law relating to groups. Important here is the principle of separate juristic personality with the concomitant doctrine of limited liability. The former doctrine is used by company-law jurists to treat each company as a separate person.⁴² It is therefore important to investigate what considerations underlie the principle of a separate juristic personality.

In the context of groups one should note that the idea of a separate juristic person developed due to historical reasons. The formalistic approach, also known as the entity theory,⁴³ should be understood in the context in which it developed, namely the relationship between the shareholder and the company in which he or she held shares.

The shareholders of an enterprise were initially natural persons and the distinction between the shareholder and the enterprise was easily visible. The company, to a large degree, was the enterprise since the concept of holding and subsidiary companies was a later development in company law. In fact, in the United States of America the New Jersey legislature only in the latter half of the 1880s and at the start of the 1890s enabled a company to hold shares in another company.⁴⁴ The entity theory was therefore developed prior to the possibility of one company holding shares in another company.⁴⁵

The enterprise, in a group context, could therefore no longer simply be seen as the company since the “company” became fragmented into a holding company and one or more subsidiaries. In practice one would have the holding company with its shareholders, for example natural persons, and then the subsidiary of the holding company. There is

⁴² See chapter 2 below.

⁴³ See in general Blumberg *The Multinational Challenge to Corporation Law* (1993).

⁴⁴ Blumberg *Corporation Law* 56.

⁴⁵ Blumberg *Corporation Law* 56.

therefore another entity separating the natural persons as shareholders and the subsidiary company. The entity theory did not have to encounter such a situation when it was developed and therefore the question should be asked whether the entity theory is still entirely appropriate in the modern era where company groups are prevalent.

Gower refers to two arguments that are used to advance the principle of separate juristic personality in English law. When the legislator introduced the concept of limited liability it wanted to promote investment by individual investors or natural persons. The idea was that these people who were not investment experts would not want to risk their personal assets by becoming shareholders of a company with unlimited liability. They would prefer being lenders to the company instead. The company, however, sought investments and not loans and to facilitate investment the concept of limited liability was introduced.⁴⁶ The argument makes sense in its historical context but does not explain the rationale behind the doctrine where one deals with a private company which is financed with shareholders' loans, and is even less apt where the investors are other companies with sufficient investment expertise.⁴⁷ The nature of a private company is an obstacle from an investment point of view since such a company must restrict the transferability of its shares and may not offer shares to the public.⁴⁸ The investment argument to justify the concept of limited liability then makes little sense.⁴⁹

Within the context of a group the second main argument has been advanced by Kraakman according to Gower.⁵⁰ This argument is called the asset partitioning rationale. In terms of this argument limited liability enables the separation of groups of assets among different companies within a corporate group. The doctrine of limited liability is portrayed as an advantage to creditors of individual subsidiary companies. The reason for this statement is that the creditors of a shareholder of a company can only hold that shareholder liable and not the company itself, which operates in favour of that company's creditors.

⁴⁶ Davies *Gower and Davies' Principles of Modern Company Law* 6ed (2003) 177. Gower refers to further more modern reasons by Halpern, Trebilock and Turnbull which will be investigated in chapter 2 below.

⁴⁷ Davies *Gower* 178.

⁴⁸ S 8(2)(b)(ii) of the new Companies Act.

⁴⁹ Davies *Gower* 178.

⁵⁰ Davies *Gower* 178.

1.6 Research hypothesis

The hypothesis of this dissertation is that the South African law on company groups is an ineffective and inaccurate reflection of the reality of a group of companies. In South Africa, due to the formalistic nature of the treatment of groups, the economic reality behind a group is, from a legal perspective, largely uncharted territory. This leads to a number of problems which have been highlighted above. The problems include the formalistic manner in which the courts treat a group of companies. The judiciary works with the premise that there is no such thing as a group of companies that constitutes a single juristic person. This is often due to an almost religious observance of the principle formulated in *Salomon v Salomon*,⁵¹ although departures from the principle are occasionally made in special circumstances.⁵²

The South African law in respect of groups of companies is outdated and does not adequately address the problems which groups of companies pose in respect of their external relations *vis-à-vis* third party creditors, whether voluntary creditors or involuntary creditors. The reason for this state of affairs is either the doctrine of limited liability or the refusal by the legislature and/or the judiciary to recognise the economic reality of a group of companies, namely that a group of companies frequently constitutes a single economic entity, although the law does not recognise this reality.

1.7 Research questions

The law of groups in South Africa is really a misnomer since there are no coherent rules of law in respect of groups of companies, only certain isolated provisions in various pieces of legislation. The South African law in respect of groups of companies is therefore inadequate for modern needs. This becomes more apparent when it is compared with that of common-law countries like the United States of America, New Zealand and Australia.⁵³

⁵¹ [1897] AC 22 [HL].

⁵² *Cape Pacific Ltd v Lubner Controlling Investments (Pty) Ltd* 1995 4 SA 790 (A).

⁵³ See chapters 6 and 7 below.

South Africa is an economic powerhouse on the African continent with a sophisticated legal system. This legal system underpins an equally developed economic and investment infrastructure in the form of a sophisticated securities exchange, the JSE. However, the law in respect of company groups is undeveloped and needs to achieve a better balance between the interests of shareholder investors on the one side, and the interests of third parties who interact with a company within a group of companies or with the group of companies itself on a daily basis. This possible conflict in the competing interests of outsiders and shareholders raises the following questions:

- (iii) Does a group of companies, in general, constitute a single business enterprise?
- (iv) If a group of companies does, in general, constitute a single business enterprise, why does the law not treat it as a single juristic entity?
- (v) Is the doctrine of limited liability an acceptable reason for the law's refusal to treat a group of companies as a single juristic entity?
- (vi) If the doctrine of limited liability is analysed in its historical context and the conclusion is that it is not the actual rationale for the law's refusal to treat a group of companies as a single juristic entity, has the doctrine become such an integral part of company law that it has become, through usage, the modern reason for the law's refusal to treat a group of companies as a single juristic entity?
- (vii) Is the reason for the law's refusal to treat a group of companies as a single juristic entity rather one of public policy?
- (viii) If a group of companies forms a single economic entity and public policy dictates that the law should not recognise this economic reality, is there an effective mechanism to act as a compromise between these two extreme poles?

This dissertation will look at the external relations of a group of companies, in particular the position of the creditors of the group of companies or the creditors of a company within the group structure. Recommendations on how best to protect these creditors in

cases of insolvency of the debtor company in a group of companies will be provided. Moreover, recommendations will be offered on how to protect involuntary creditors where they have suffered loss due to the actions of a company within a group of companies.

The question which also needs to be answered is whether mere domination triggers the protection for the respective affected parties from the might of the holding company or whether abuse of the holding company's position *vis-à-vis* the subsidiary is necessary. This is a very important question to address in respect of the external relations of the holding company or group, in the light of limited liability and the few exceptions to the doctrine. It is submitted that if the position of external parties, namely voluntary and involuntary creditors, is to be regulated differently from the current position that they have in law, some form of abuse still has to take place before the law should protect them. The key concept is balance: there will have to be some balance between the interests of these external creditors and the interests of the entities within the group. The doctrine of limited liability should, however, also be reconsidered in order to protect the position of external parties adequately.⁵⁴ The reason for the re-evaluation is to determine the role of the doctrine within its historical context so as to refine its role in the modern economic and legal order.

Muscat identifies four categories of abuse or unfairness within the group context which could *prima facie* be prejudicial to the external creditors of a member of a company group.⁵⁵ The first occurs where the subsidiary company engages in activities which are not necessarily in its own interests but in the interests of the other group members, whether the holding company or a co-subsidiary company. One issue for example is the use of the profits of a subsidiary as dividends within the group or to finance other members of the group instead of securing the long-term health and viability of the individual subsidiary company. Another issue which comes to the fore is the issue of internal "transfer pricing".⁵⁶ Transfer pricing is the movement of funds within groups.

⁵⁴ See chapters 6 and 7 for a more detailed discussion.

⁵⁵ Muscat *The Liability of the Holding Company for the Debts of its Insolvent Subsidiaries* (1996) 64.

⁵⁶ Muscat *Liability of the Holding Company* 68-73.

This movement can take various forms: the declaration and payment of dividends, soft loans,⁵⁷ the provision of services and the use of intellectual property.⁵⁸

The second is where the subsidiary company has not been adequately capitalised so that the interests of external creditors are put in danger. The inadequate capitalisation of a subsidiary may, to some extent, be off-set by the requirements of solvency and liquidity in the new Companies Act,⁵⁹ although this may only be of assistance in a limited number of circumstances.

The third occurs where one business is sub-divided into a number of separate juristic entities. The single business entity situation will be investigated later where it will be shown that where a group is organised in a vertical chain, this is often done to integrate the production chain and that this chain forms one whole.⁶⁰ As already mentioned the law does not in principle recognise this reality.

The fourth is where the external creditors of a group member are under the (mistaken) belief that they are dealing with the group or that the holding company will stand in for the obligations of the relevant group member.⁶¹ The fourth category often involves the holding company providing letters of comfort⁶² to a creditor of a subsidiary company only for the creditor of the subsidiary company to realise later that the letter of comfort is meaningless.⁶³

1.8 Overview of the dissertation

Chapter two will address the doctrine of limited liability in common-law countries by investigating the reasons for its existence and the exceptions to it. The chapter will also investigate the development of groups of companies in the United Kingdom and the

⁵⁷ Loans on generous terms which terms would not have been obtained had the parties been at arm's length.

⁵⁸ Muscat *Liability of the Holding Company* 68.

⁵⁹ S 4 and see the further discussions below in chapter 5, paras 5.3.2, 5.3.3, 5.3.5 and 5.3.6.

⁶⁰ Chapter 3.

⁶¹ Muscat *Liability of the Holding Company* 64-65.

⁶² A letter of comfort is a commitment of a holding company to a creditor of a subsidiary which is in principle not legally enforceable.

⁶³ See para 7.7 below.

United States of America and how the judiciary and the respective legislatures dealt with the phenomenon of a group of companies in the light of the doctrine of limited liability.

Chapter three will address the economic reality of groups and show that many groups of companies in practice constitute single economic entities.

The development of limited liability in Germany, the historical development of enterprise law and the relevant provisions of the German *Konzernrecht*⁶⁴ will be discussed in chapter four. This will be done to illustrate that there are sophisticated jurisdictions, both legally and economically, which have acknowledged the economic realities of groups of companies without suffering economically. This refutes the argument, which could be raised, that investors would be scared off should the law recognise the single economic juristic entity of a group in certain circumstances.

Chapter five will consider the legislative and judicial attempts to address groups of companies in South Africa. In this respect the provisions of the new Companies Act and other statutes will be investigated. The reason for this investigation is to show that since the legislature has accepted the need to address groups of companies in some respects, there are no cogent policy reasons for the judiciary and the legislature not to address the problem areas highlighted in this dissertation.

Chapters six and seven will address the external relations of a group of companies by looking at the possible delictual liability of a holding company for the harm caused by its subsidiary as well as the position of the creditors of an insolvent member of a corporate group. The law in this respect of, amongst others, the United States of America, Australia and New Zealand will be investigated since these jurisdictions have addressed the highlighted problems in a manner which could be beneficial to South African law, without opening the floodgates of unrestricted liability of holding companies for the debts of their insolvent subsidiaries or the delicts committed by them.

⁶⁴ Enterprise law

The reason for comparing these jurisdictions is due to the fact that South African company law shares many similarities with these jurisdictions. The new Companies Act has also been based, to a degree, on the Model Business Corporations Act of the United States and therefore strengthens the argument for comparison. New Zealand and Australia, although being classified as more developed markets and economies than South Africa, are relatively similar to South Africa in their respective business environments. Given these factors it is submitted that South African company law could learn much from these jurisdictions and even adopt some of the measures taken by the legislature and judiciary in these jurisdictions.

The chapters on the law of delict and the law of insolvency will conclude with recommendations to change the existing law on groups by introducing certain statutory amendments.

Chapter 2

The doctrine of limited liability in common-law jurisdictions

2.1 Introduction

“The rational study of law is still to a large extent the study of history. History must be a part of the study, because without it we cannot know the precise scope of rules which it is our business to know.”¹

It is trite that a company is a separate artificial juristic person.² This means that a company is the bearer of its rights and obligations and enjoys perpetual succession. A change in membership or shareholding of the company therefore has no effect on the continued existence of the company. The further effect of separate juristic personality is that it is the company which is liable for its debts and any advantages which accrue to the company belong to the company and do not form part of the estates of its members or shareholders.

Limited liability, which generally is a concession granted by the state, is often viewed as one of the natural consequences of separate juristic personality. This means that should failure of the business of the company lead to the liquidation of the company, the creditors of the company have no recourse against the shareholders of the company. The risk for the shareholders is restricted to the amount which they invested in the company. Limited liability and the inability of creditors to demand payment for the obligations of the company from its shareholders, are not restricted to cases of liquidation. Creditors are also in principle precluded from demanding payment from the shareholders of the company during the existence of the company subject to certain exceptions.³

Groups of companies consist of individually incorporated companies. As such each company has separate juristic personality. The holding company, as controlling

¹ Holmes “The Path of the Law” 1897 *Harvard Law Review* (10) 457 469.

² Berle “The Theory of Enterprise Entity” *Columbia Law Review* 1947 (47) 343.

³ The personal liability company in South African law, for example, which provides that the directors of the company are jointly and severally liable for the contractual debts of the company incurred during their terms of office.

shareholder of the subsidiary company, also therefore enjoys the shield of limited liability. The question is why does limited liability exist? To answer this question the evolution of the company has to be evaluated to determine the reasons for limited liability. Once this has been established the next question will be whether the reasons for limited liability in respect of companies where the shareholders are natural persons apply equally to situations where the shareholder(s) of a company is/are other juristic persons. To answer these questions limited liability will be investigated from a historical perspective, an economic perspective and a legal perspective. At the end of the section on limited liability it will also be viewed from a revisionist approach.

2.2 The doctrine of limited liability in its historical context in common-law countries

2.2.1 The United Kingdom

Medieval England was acquainted with a corporate entity although this entity was mainly restricted to ecclesiastical and public organisations. This status of being equipped with corporate personality was mainly granted by the Crown.⁴ The bodies which were granted the status of corporate personality were primarily focused on obtaining monopolies in the various forms of trade in which they were engaged or interested. According to Gower these associations were guilds of trade organisations which are very dissimilar to the modern corporation as we know it. The reason for this is the fact that it was unnecessary to separate the rights and obligations of individual members of guilds from those of a body to which they belonged, since every member conducted trade for his own account. The only obligation of the member was to comply with the rules of the particular guild of which he was a member.⁵

Individuals who did not wish to trade under the auspices of a guild, but who also chose not to trade on an individual basis, had as the only option available to them the formation of a partnership.⁶ Traders in medieval times had the choice between two forms of partnership. One of the options was the *commenda* which consisted of the entrepreneur trader and the financial backer, who could be compared to a silent partner and whose

⁴ Gower *Principles of Modern Company Law* 5ed (1992) 19.

⁵ Gower *Principles* 20.

⁶ Cilliers *Limited Liability in Company Law* LLD Dissertation UNISA (1963) 24.

liability was restricted to the investment which he made in the enterprise.⁷ In continental Europe the *commenda* as known in England evolved into the *société en commandite*.⁸

The other partnership available during medieval times was the *societas* which had a greater degree of permanence to it and evolved into the common form of partnership as it is known today. In this form of enterprise each partner could act as the agent of the other partners and would be liable only to the extent of his contribution to the enterprise. In essence this was akin to limited liability.

The name “company” was ascribed initially to merchant traders who conducted trade abroad based upon charters which were granted by the Crown. This can be traced to as early as the fourteenth century although it was not generally in use. When foreign trade became more common, coupled with new frontiers being discovered, this type of company became increasingly common from about the sixteenth century.⁹

The companies which existed due to charters granted by the Crown were largely extensions of the earlier guilds. According to Gower, an individual member of a company conducted trade with his own stock and at his own expense. The member, however, still had to comply with the rules imposed by the company. Incorporation was not necessary therefore since every member was responsible for his own liabilities. Charters were, however, essential to obtain a monopoly in respect of foreign trade and the power to govern over foreign territory.¹⁰

In time the underlying principle of a partnership, namely the conduct of business between two or more persons by means of a joint pool of assets, became a more attractive proposition for companies and these companies evolved into entities that were more commercially orientated compared to the more protective enterprises they had been

⁷ Cilliers *Limited Liability* 25.

⁸ Farrar, Furey & Hannigan *Farrar's Company Law* 3ed (1991) 16.

⁹ Gower *Principles* 21.

¹⁰ Gower *Principles* 21.

before.¹¹ The East India Company was one of the groundbreaking entities which introduced the concept of a joint pool of assets outside the partnership enterprise form. The East India Company was granted a charter in 1600 which enabled it to monopolize trade to the Indies. At its inception the East India Company functioned like any other company of that time in that individual members conducted trade for their individual account but always subject to the rules of the company. However, the East India Company also provided for a dual system which allowed members to subscribe to a joint stock, over and above the traditional permission to trade for one's own account under the auspices of the company.¹² This state of affairs initially led to a situation where the joint pool of assets and profits were divided among the subscribers to the joint pool after the completion of each foreign expedition.¹³ Between 1614 and 1653 the members of the company could subscribe to the joint pool of assets for any number of years. Between 1653 and 1692 a permanent pool of assets was introduced. After this the members of the company were prohibited from trading for their individual accounts.¹⁴ Up to 1692 therefore the company was a hybrid between the modern company as we know it, which conducts business for the benefit of its members, and a mere governance mechanism for a particular trade. The new form of company was then called a joint stock company to refer to the joint pool of assets.¹⁵

According to Gower arguably the single biggest advantage of incorporation, namely limited liability, was only realised as an afterthought. By the early fifteenth century this advantage was already enjoyed by the members of non-trading corporations and by the end of the seventeenth century in the case of trading companies.¹⁶ Members of companies, however, apparently did not at first fully comprehend the value of limited liability since it was initially understood to protect the company's assets against forfeiture for the private debts of members, whereas today the advantage of limited liability is seen more as a benefit for the member that his assets are in principle safe from attachment by

¹¹ Gower *Principles* 21.

¹² Cilliers *Limited Liability* 29.

¹³ Gower *Principles* 21.

¹⁴ Cilliers *Limited Liability* 30.

¹⁵ Hadden *Company Law and Capitalism* (1972) 6; see also Gower *Principles* 21.

¹⁶ Gower *Principles* 22 with reference to *Edmunds v Brown & Tillard* (1668) 1 Lev 237.

the creditors of the company.¹⁷ The advantage of limited liability, in any event, served very little practical purpose since the constitutions of most companies enabled them to call upon their members to make contributions, which companies would inevitably do when creditors had to be paid. Creditors even had the right to proceed against members where the company failed to pay its debts.¹⁸

By the middle of the seventeenth century the companies which were in existence came under pressure to relinquish their monopolies especially in respect of the governance of the territories where their monopolies were vested. After the French revolution the right to grant monopolies was removed from the Crown and instead vested in the state and could only be conferred by means of statute.¹⁹

Although there was a decline in respect of incorporation of foreign companies, incorporation of more domestically inclined companies was on the increase. Companies like the Bank of England, which was incorporated initially under charter and then later under statute in 1694 were, or became, powerful entities.²⁰ These companies were akin to the modern day public company seeking investment from the public at large.

Towards the end of the seventeenth century the symbiotic potential between an investor in a business and an entrepreneur became a more realistic possibility with the advent of joint stock companies. Stock broking became a career opportunity and the purchase and sale of shares were an everyday occurrence.²¹ Unfortunately, the dealing in shares lent itself to abuse which necessitated intervention by the English legislature in 1697.²² According to Gower there still was no proper company law at the turn of the seventeenth century but more of an “embryonic law of partnership.”²³ Company law was really still only partnership law at its conception stage since this law only applied to companies which were not incorporated. The partnership agreements, later to become deeds of

¹⁷ Gower *Principles* 23.

¹⁸ Hadden *Company Law* 15 with reference to *Salmon v Hamborough Company* (1671), 1 Ch. Cas. 204.

¹⁹ Gower *Principles* 24.

²⁰ Hadden *Company Law* 10.

²¹ Hadden *Company Law* 9.

²² Farrar *Farrar's* 17.

²³ Gower *Principles* 24.

settlement, and the charters which were granted to certain entities were strongly influenced by the guilds of earlier centuries especially with regards to the management of the entities. Management vested in governors and assistant governors but at the end of the seventeenth century the term “assistant governor” was replaced by the term “director.”²⁴

The eighteenth century did not start off well for company law. Disaster struck in the form of the South Sea Bubble. The South Sea company aimed to acquire the whole of the national debt of England. In short, it proved to be a disastrous scheme and nothing more than a glorified gamble.²⁵

The South Sea scheme led to other highly speculative schemes, which necessitated intervention by the legislature although the resulting legislation probably had more disastrous consequences than those of the speculative schemes.²⁶ The House of Commons passed a resolution in 1720 which attempted to address the wave of speculative schemes which occurred during that period and later that year passed the Bubble Act.²⁷ It appears that the purpose of the Bubble Act was to prevent a company from acting as a corporate entity and from issuing shares without valid authority in the form of a charter or an Act of Parliament.²⁸ Gower quotes Holdsworth who said that;

“[W]hat was needed was an Act which made it easy for joint stock societies to adopt a corporate form and, at the same time, safeguarded both the shareholders in such societies and the public against frauds and negligence in their promotion and management. What was passed was an Act which deliberately made it difficult for joint stock societies to assume a corporate form and contained no rule at all for the conduct of such societies, if, and when, they assumed it.”²⁹

The commentators are in agreement that the Bubble Act was very vague which made interpretation very difficult.

²⁴ Gower *Principles* 24.

²⁵ Cilliers *Limited Liability* 44.

²⁶ Farrar *Farrar's* 18.

²⁷ 6 Geo 1, ch 18.

²⁸ Farrar *Farrar's* 18.

²⁹ Gower *Principles* 26 with reference to Holdsworth *History of English Law* 8 219-220. Farrar *Farrar's* 18 quotes Maitland *Collected Papers* 3 “Trust and Corporation” 390 who referred to the Bubble Act as something which “seems to scream at us from the Statute Book.”

Whether the legislature intended it or not is debatable, but the Bubble Act proved to be disastrous for public confidence in the companies which existed at that stage. Furthermore legal steps were taken against a number of corporations which conducted business in terms of charters which had expired.³⁰ These factors in tandem led to massive panic sales by stockholders which reduced the stock value of South Sea Company within six months from 1000% to 125%. Public confidence was very low hereafter and a comeback by joint stock companies could be seen only towards the end of the eighteenth century.³¹

Joint stock companies did not completely disappear after the enactment of the Bubble Act.³² Numerous properly run chartered companies and a number of companies which had not been incorporated managed to survive the negative sentiment which swept the investing public and were examples of the positives of such enterprises.³³ The Bubble Act led to fewer charters being issued with more stringent conditions.³⁴ Towards the end of the century, however, statutory incorporations became more common. According to Gower statutory incorporation reflected many of the norms which are taken for granted today, for example that the liability of members was restricted to the nominal value of their shareholding.³⁵

Although the Bubble Act sought to end the unincorporated company it allowed partnerships. However, the parameters within which partnerships could operate were not quite clear. There was no limit on the number of partners. It would appear that initially legality of the partnership was dependent on the presence of a restriction on the transfer of shares. By the middle of the eighteenth century, however, with the Bubble Act already reduced to an anachronism, freedom to transfer shares took hold.³⁶

³⁰ Cilliers *Limited Liability* 45.

³¹ Gower *Principles* 27.

³² Farrar *Farrar's* 19.

³³ Gower *Principles* 28.

³⁴ According to Cilliers *Limited Liability* 48, a further consequence was also as to act as a stimulus for the ultra vires doctrine since the Act attempted to restrict companies in respect of their capacity; ie that they could only use their charters for the goals for which they were granted.

³⁵ Gower *Principles* 28. See also Hadden *Company Law* 13.

³⁶ Hadden *Company Law* 12.

The companies which were not incorporated took innovative measures to have the advantages of an incorporated company. These measures included conducting the business under a “deed of settlement” in terms of which the members of the association would agree to come together in an enterprise with a joint stock which would be divided into an agreed number of shares. Furthermore any amendments to the deed had to be agreed upon by a specified number of members, the management would vest in a committee of directors and the property of the enterprise would vest in a separate body of trustees which would usually include some of the directors. Provision would also be made for litigation by and against these trustees.³⁷

In time the disadvantages of unincorporated entities became more pronounced as more and more of these entities began to conduct business. It was mentioned before that the deeds of trust allowed the trustees to sue and be sued, but whether this was legally sound was not clear. The unincorporated entities which existed were in law nothing more than partnerships and during that period the law did not allow litigation by or against the entity, but it had to be instituted by or against all the individual partners, which was problematic especially where transfer of shareholdings took place.³⁸ Coupled with this disadvantage was the personal liability which partners would incur in an unincorporated entity.

Members of unincorporated entities only realised by the late eighteenth century that the lack of limited liability was problematic in their unincorporated environment. From about 1770 entities which sought incorporation were motivated by the advantage of limited liability. With unincorporated entities a general clause in the deed of settlement would not suffice to gain the advantage of limited liability and had to be specifically included when the entity entered into a contract with a third party.³⁹

Gower avers that unlimited liability was no impediment for a dishonest promoter of an unincorporated company due to the difficulties to sue a fluctuating body of members and

³⁷ Farrar *Farrar's* 19.

³⁸ Hadden *Company Law* 12.

³⁹ Hadden *Company Law* 15; Cilliers *Limited Liability* 37.

even when judgment was obtained to levy execution. Practical problems facing creditors therefore made unlimited liability less of a problem for the unscrupulous promoter.⁴⁰

There were thus numerous problems which only appropriate state intervention could solve to protect the investing public against unscrupulous promoters and managers, but which would also allow and stimulate the incorporation of entities. The legislature could not think of anything better than to repeal the Bubble Act on the recommendation of the Board of Trade in 1825.⁴¹

There was no significant movement in company law between 1825 and 1844 and limited liability was still the single most important aspect that needed to be addressed.⁴² At this stage limited liability still met with considerable hostility.⁴³ The groundbreaking period for English company law was 1843 onwards. First of all the Parliamentary Committee on Joint Stock Companies issued a significant report which led to the Joint Stock Companies Act of 1844 which introduced principles like registration as a means to obtain incorporation and publicity.

Limited liability, however, was still not addressed. Although the 1844 Act retained the personal liability of members,⁴⁴ the liability was restricted. Shareholders could only be held liable for the debts of the company for a fixed period. Liability would terminate three years after any transfer of the shares. Creditors who demanded payment furthermore first had to seek satisfaction against the assets of the company.⁴⁵ Four types of business entities were available to entrepreneurs following the 1844 Joint Stock

⁴⁰ Gower *Principles* 33.

⁴¹ Farrar *Farrar's* 19.

⁴² There was the Trading Companies Act of 1834 which allowed letters of patent to be conferred without the necessity of granting a charter, the Chartered Companies Act of 1837 which allowed a form of limited liability and the Bellenden Ker report of 1837, which investigated the continental system of limited partnerships, the *société en commandite*, but which was shelved. In this regard see Cilliers *Limited Liability* 69-82.

⁴³ According to *The Times* in an editorial of 25 May 1824, as quoted by Halpern, Trebilcock & Turnbull "An Economic Analysis of Limited Liability in Corporation Law" 1980 *University of Toronto Law Journal* (30) 117. "nothing can be so unjust as for a few persons abounding in wealth to offer a portion of their excess for the formation of a company, to play with that excess – to lend the importance of their whole name and credit to the society, and then should the funds prove insufficient to answer all the demands, to retire into the security of their unharmed fortune, and leave the bait to be devoured by the poor deceived fish."

⁴⁴ S 25.

⁴⁵ Gower *Principles* 39.

Companies Act. There were first of all unincorporated private partnerships which were restricted to a maximum of 25 persons and who incurred personal liability. Secondly, there were chartered companies, thirdly, statutory companies whose members had limited liability or whose personal liability was restricted to a fixed amount. Lastly there were companies which were incorporated under the 1844 Act but whose members did not enjoy limited liability.⁴⁶

Mention was made earlier of a report by Bellenden Ker⁴⁷ which investigated the continental *société en commandite* partnership where partners enjoyed limited liability. In 1850 the Select Committee on Investments for the Savings of the Middle and Working Classes was formed and one of its findings was that investment by these classes would be stimulated by limited liability.⁴⁸ In 1851 there was a report by another committee which investigated partnerships and again the committee failed to address the issue of limited liability in a constructive manner. It did, however, recommend that the issue of limited liability should be referred to a royal commission.⁴⁹

In 1854 representatives of Scotland, Ireland and England formed a royal commission to investigate limited liability. Limited liability was eventually provided for in the Limited Liability Act of 1855.⁵⁰

2.2.2 Limited liability and company groups in England

Groups of companies emerged immediately with the advent of the modern company law in the mid-nineteenth century. The power of companies to acquire shares in other companies had to be provided for specifically in the memorandum of association of a company. The absence of such an enabling provision would make any acquisition of shares by a company in another company *ultra vires*.⁵¹

⁴⁶ Goldenberg *Guide to Company Law* 4ed (1997) 1.

⁴⁷ N 35 above.

⁴⁸ See further Gower *Principles* 42.

⁴⁹ Gower *Principles* 43.

⁵⁰ Farrar *Farrar's* 20.

⁵¹ Muscat *The Liability of the Holding Company for the Debts of its Insolvent Subsidiaries* (1996) 1.

Muscat argues that limited liability was introduced due to socio-economic factors and had nothing to do with separate juristic personality.⁵² With reference to the Companies Clauses Consolidation Act,⁵³ the Joint Stock Companies Act,⁵⁴ the Joint Stock Companies Winding-up Act,⁵⁵ the Chartered Companies Act,⁵⁶ and the writings of Grant⁵⁷ Muscat concludes that corporate shareholding in another company was possible. However, he argues that this did not necessarily imply that one company could hold the majority of shares in another company.⁵⁸ Muscat argues that at the time when limited liability was debated and contemplated, it would have been highly unlikely that the holding company controlling a subsidiary company was contemplated in the light of the fact that the goal of limited liability was to provide a safe platform for a number of investors to pool their assets in a separate person with limited liability.⁵⁹ The goal was not that a single corporation would control another company.

Initially limited liability was proposed to be restricted to associations of 25 persons or more but this minimum number was reduced to seven a year later.⁶⁰ The fact that at least seven members were required naturally excluded the possibility of a wholly owned subsidiary. Muscat refers to heated debates about the requirement of seven members and what it meant.⁶¹ He mentions that some commentators raised the possibility of people nominally allowing 6 others, for example “servants to hold a share and the real shareholder holding the remaining ninety four shares which in effect resulted in one person companies.”⁶² In practice, however, entrepreneurs started to make use of this mechanism of nominal shareholders which ultimately led to *Salomon v A Salomon and Co Ltd*⁶³ which for all intents and purposes dealt with a company with a single substantial

⁵² Muscat *Liability of the Holding Company* 155.

⁵³ Companies Clauses Consolidation Act of 1845.

⁵⁴ Joint Stock Companies Act of 1844.

⁵⁵ Joint Stock Companies Winding-up Act of 1848.

⁵⁶ Chartered Companies Act of 1837.

⁵⁷ Grant *A Practical Treatise on the Law of Corporations* (1850).

⁵⁸ Muscat *Liability of the Holding Company* 156.

⁵⁹ Muscat *Liability of the Holding Company* 156.

⁶⁰ Muscat *Liability of the Holding Company* 156 with reference to the Limited Liability Bill 1855 and the eventual Joint Stock Companies Act of 1856.

⁶¹ Muscat *Liability of the Holding Company* 157.

⁶² Muscat *Liability of the Holding Company* 157.

⁶³ *Salomon v A Salomon and Co Ltd* [1897] A.C. 22 [H.L.]. For further discussion see para 2.4 below.

shareholder, the interests of the other shareholders being purely nominal. The fact that a single shareholder was *de facto* allowed implied that it would have been possible for a company to be the dominant shareholder in another at the time of the *Salomon* case.⁶⁴ Muscat concludes that in none of the parliamentary debates or discussions on limited liability was the issue of corporate shareholding ever raised. He states that

“And yet, without any apparent awareness – let alone discussion – of the profoundly different considerations, limited liability was automatically extended from the individual investor (who was clearly the intended beneficiary of the principle) to the corporate member and then onto the holding company. *The creation of two or more strata of insulation from liability appears to have come about fortuitously.*”⁶⁵

2.2.3 Limited liability in the United States of America

The most significant developments in respect of company groups can be found in the United States of America. It is difficult to determine precisely when limited liability became the norm in the United States in the light of the fact that corporate law developed at state level rather than at the federal level in the United States of America. The first companies in the United States were, as in England, also chartered companies which were engaged in various business sectors like construction and banking.⁶⁶ By 1801 there were already 335 companies in the post-revolution United States which were all granted charters by their respective states.⁶⁷ Limited liability was also to a large degree a foreign concept and in most states the charters provided for liability for the debts of the company by the shareholders.⁶⁸ In certain sectors, however, limited liability was more important.⁶⁹ There are, however, few reported judgments prior to 1800 and therefore the true extent of limited liability in early corporate United States is unknown.⁷⁰

⁶⁴ Muscat *Liability of the Holding Company* 158.

⁶⁵ Muscat *Liability of the Holding Company* 158 (my italics).

⁶⁶ Dodd *American Business Corporations until 1860* (1954) 12.

⁶⁷ Berle & Means *The Modern Corporation and Private Property* (1932) 10.

⁶⁸ Blumberg “Limited liability and corporate groups” 1986 *Journal of Corporate Law* 11 573 587.

⁶⁹ Blumberg *The Multinational Challenge to Corporation Law* (1993) 10. The charters for financial institutions often provided for limited liability. See for example the 1789 charter of the Bank of New York.

⁷⁰ Dodd *American Business Corporations* 12.

Limited liability soon became more relevant with the expansion of the number of companies and the growth in the manufacturing sector.⁷¹ The American judiciary already recognised the concept of limited liability in the early nineteenth century.⁷² According to Blumberg the state legislatures in due course followed suit. Whereas early statutes provided for direct liability of shareholders of companies, this trend eventually changed due to the rapid increase in the number of companies.⁷³ California is an example of a large state and economy which resisted the change for a number of years until early in the twentieth century.⁷⁴

Prior to the reform, Californian law provided for unlimited liability of the shareholders. Shareholders were not jointly and severally liable for the debts of the companies in which they held shares but rather proportionally to the size of their shareholding.⁷⁵ The Californian legislation was far reaching since it also applied to companies which were not incorporated in California but which conducted business in California. Furthermore it also applied regardless of whether the company legislation of the state of incorporation provided for limited liability.⁷⁶ States were therefore forced to enforce Californian judgments against their own residents if those residents were shareholders of companies which conducted business in California. This was held not to be unconstitutional.⁷⁷

According to Blumberg the Californian law was not *de facto* as draconian as it appeared to be. It allowed shareholders to contract out of liability and the statutory liability prescribed three years after the date on which the obligation had originally been incurred and not within three years of default.⁷⁸

⁷¹ Berle & Means *Modern Corporation* 14 and Blumberg *Corporation Law* 11.

⁷² Blumberg *Corporation Law* 11 with reference to *Wood v Dummer* which was decided in 1824.

⁷³ Blumberg *Corporation Law* 11 with reference to New Jersey in 1816, Connecticut in 1818, Maine in 1823, Massachusetts in 1830 and New England in 1847.

⁷⁴ Blumberg *Corporation Law* 12.

⁷⁵ Blumberg *Corporation Law* 12, 13.

⁷⁶ Blumberg *Corporation Law* 13.

⁷⁷ Blumberg *Corporation Law* 13 with reference to *Thomas v Matthiessen*, 232 US 221 (1914) and *Pinney v Nelson*, 183 US 144 (1901).

⁷⁸ Blumberg *Corporation Law* 13.

2.2.4 Limited liability and company groups in the United States of America

2.2.4.1 Introduction

Limited liability was initially a non-issue in the United States in respect of company groups as it was not allowed at all. In the nineteenth century it was initially impossible for one company to own shares in another subject to certain exceptions.⁷⁹ A bank, for example, could hold shares in a construction company, if the bank had an interest in the building.⁸⁰ Contracts to purchase shares by one company in another were seen to be *ultra vires* and therefore unenforceable.⁸¹ By 1855 some companies in some industries were allowed by certain states to own up to ten percent of shares in another company.⁸² According to Cook the shareholder of a company, which contemplated the purchase of shares in another company, could not object to that purchase, despite the fact that the purchase would be *ultra vires* the company.⁸³

According to Blumberg the prohibition remained unchallenged for most of the early and mid-nineteenth century with a few exceptions.⁸⁴ He does, however, mention that there were also statutory exceptions to the general prohibitions. These statutory exceptions were mainly in three areas: banks and insurance companies could purchase shares in other companies for the purposes of investment in the fields of water, gaslight and the railroads.⁸⁵ The railroads were significant in that the expansion of the United States towards to the west was stimulated by a rapidly increasing rail track system. By allowing the holding of shares by one company in another the expansion was stimulated through the interconnection of different companies' lines.⁸⁶

⁷⁹ Cook *The Principles of Corporation Law* (1925) 100.

⁸⁰ Cook *Principles* 100.

⁸¹ Cook *Principles* 100.

⁸² Dodd *American Business Corporations* 354 with reference to Act of April 6, 1855. Massachusetts Acts and Resolves 1854-55, c 146, p584.

⁸³ Cook *Principles* 101.

⁸⁴ Blumberg *Corporation Law* 54.

⁸⁵ Compton "Early History of Stock Ownership by Corporations" (1940) *The George Washington Law Review* 9 125 126.

⁸⁶ Blumberg *Corporation Law* 55.

According to Bonbright and Means⁸⁷ the Baltimore and Ohio Railroad Company could be considered to be the first holding company in the United States since it was allowed by the state of Maryland to purchase the majority of shares in the Washington Branch Road in 1832 or 1833. Bonbright and Means, however, aver that the incorporation of a number of companies which obtained legislative charters to own shares in other companies was thought “to have been the result of legislative favouritism and corruption”.⁸⁸

Despite the abovementioned exceptions the holding of shares by a company in another was still only allowed if the former’s charter allowed this. The doctrine of *ultra vires* still acted as a general bar in the absence of authority in a charter.⁸⁹ According to Blumberg entrepreneurs found innovative ways to consolidate control of various companies, for example, by using a trust.⁹⁰ The shelf life of the trust device was short lived, as antitrust legislation in various sectors soon followed at the end of the nineteenth century.⁹¹

New Jersey was the first state which earnestly sought licence fees from incorporated companies.⁹² The state drew numerous companies to register in the state due to its adoption of legislation authorising the holding of shares in other companies. Bonbright and Means state in this context:

“When the title state of New Jersey, eager to enrich its treasury with license fees from corporate promoters, amended its general corporation law so as to permit corporations freely to hold the stocks of other corporations, it took a step the economic consequences of which have seldom been equalled in the entire history of business legislation. For it thereby opened the door for the entry of the holding company as the leading device for combining enterprises under common control and management.”⁹³

⁸⁷ Bonbright & Means *The Holding Company, its public significance and its regulation* (1932) 58.

⁸⁸ Bonbright & Means *The Holding Company* 60.

⁸⁹ Blumberg *Corporation Law* 55.

⁹⁰ Blumberg *Corporation Law* 55 with reference to the Sherman Antitrust Act of 1890.

⁹¹ Blumberg *Corporation Law* 55.

⁹² Bonbright & Means *The Holding Company* 57 with reference to New Jersey Laws of 1888, chapter 269, s 1, 385 and chapter 295, s 1 445.

⁹³ Bonbright & Means *The Holding Company* 57. See also Blumberg *Corporation Law* 56-57 who avers that the legislation was adopted in New Jersey due to its income revenue problems and thus the adoption of the legislation could be justified politically. The legislation of New Jersey was so successful that it became a fund generating cash cow. By 1902 the State of New Jersey had repaid its public debt and the income generated by incorporation fees covered the budget of New Jersey at that time.

According to Bonbright and Means the New Jersey legislature felt the need to clear up any ambiguities and amended the statute in 1889 and broadened its extent in 1893.⁹⁴ The success of New Jersey led to other states following suit.⁹⁵ Not everybody was happy though and some saw it as the start of great conglomerates. Blumberg quotes a journalist, Steffens, who described the action of the New Jersey legislature as “New Jersey: A Traitor State. How She Sold Out the United States.”⁹⁶ According to Blumberg the initial New Jersey Act was not as radical as the quoted response would suggest. It merely provided for some form of “vertical integration” by allowing a company to purchase shares in another company which served as a supplier for the business of the company purchasing those shares.⁹⁷ Later amendments of the initial enabling Acts went further and provided for the unrestricted power of companies, which were incorporated in New Jersey, to obtain the shares in other companies with the consent of the directors of the purchasing company.⁹⁸

In respect of the judiciary’s attitude towards the holding of shares by companies in other companies the position was that there was antagonism to such a situation. The rationale for such prohibition, namely that one company could not hold shares in another, lay in the courts’ refusal to extend the powers of companies beyond those which were granted by the respective legislative charters or the relevant company’s constitution. The power to hold shares in another company therefore had to be expressly granted to a company.⁹⁹ A company only had certain powers in terms of its constitution and any act beyond these powers was *ultra vires*.¹⁰⁰ This view was confirmed in *De La Vergne Refrigerating*

⁹⁴ Bonbright & Means *The Holding Company* 57 with reference to New Jersey Laws of 1889, chapter 265, s 4, 414; New Jersey Laws of 1893, chapter 171, s 1 301.

⁹⁵ Bonbright & Means *The Holding Company* 57 referring to New York Laws of 1892, chapter 688, s 40, 1834; Connecticut Laws of 1895, chapter 138, s 1, 514; Pennsylvania Laws of 1895, chapter 261, s 1, 370; Delaware Laws of 1899, chapter 273, s 133 500. By 1929 thirty nine states have statutorily provided for the ownership of shares by companies in other companies. According to Bonbright & Means the courts in other states ruled that, in the absence of a statutory enabling provision, the companies were entitled to amend their constitutions to allow the ownership of shares by company in another.

⁹⁶ Blumberg *Corporation Law* 57.

⁹⁷ Blumberg *Corporation Law* 56.

⁹⁸ Blumberg *Corporation Law* 56.

⁹⁹ Blumberg *Corporation Law* 53.

¹⁰⁰ Blumberg *Corporation Law* 53.

Machine Co v German Savings Institution.¹⁰¹ In *Buckeye Marble & Firestone Co v Harvey*¹⁰² the court not only stated that such shareholding was *ultra vires*, but was also influenced by the concern that it could lead to the establishment of monopolies, which also had to be avoided.

According to Blumberg,¹⁰³ the courts' antagonism towards the holding of shares by a company in another could be seen as a way of resisting the control which could be gained. Courts looked at the constitutions of companies and if they did not provide for the control of another company it would be *ultra vires* to acquire or exercise control even if they permitted shareholding in another company.¹⁰⁴ Courts would therefore not allow such shareholding in the absence of an enabling provision in the charters of the companies and such a power to hold shares in another company would also not be implied by the courts.¹⁰⁵ Compton advances a number of reasons for this resistance including jealousy by the state of the power of large corporations, the risk for the shareholders of the holding company, public policy, unfairness towards the company in which shares were to be purchased and the fact that it was against the provisions of a company's charter which was to be interpreted strictly.¹⁰⁶ Compton does not, however, provide any details for these reasons against the holding of shares in one company by another. A brief history of the development of the courts' attitude towards companies holding shares in other companies will now be provided to show how the initial antagonism which Blumberg refers to changed in time.

2.2.4.2 *The early attitude of the United States' courts in respect of limited liability in company groups*

Probably the first reported case in respect of corporate groups was *New York and Maryland Line Railroad Company, Plaintiff in Error v Winans*.¹⁰⁷ The plaintiff was a

¹⁰¹ *De La Vergne Refrigerating Machine Co v German Savings Institution* 175 US 40, (1899).

¹⁰² *In Buckeye Marble & Firestone Co v Harvey* 92 Tenn 115, 118, 20 SW 427, 428 (1892).

¹⁰³ Blumberg *Corporation Law* 54.

¹⁰⁴ Blumberg *Corporation Law* 54.

¹⁰⁵ Compton *Early History* 130.

¹⁰⁶ Compton *Early History* 131.

¹⁰⁷ *New York and Maryland Line Railroad Company, Plaintiff in Error v Winans* 58 US 30, 17 How.30, 1854 WL 7512 (US Pa), 15 L. Ed. 27.

company incorporated in Pennsylvania and was the subsidiary of a Baltimore and Susquehanna Railroad Company which was incorporated in Maryland. The plaintiff operated a railroad from York (Pennsylvania) up to the border of the state with Maryland where the holding company continued the railroad to Baltimore. The subsidiary allegedly infringed on certain patented rights in respect of its railroad carriages and legal action was instituted against it by the respondent.

The subsidiary then argued that it could not be liable because it and its holding company were one company and that the holding company should therefore be held liable, i.e. a “reverse piercing of the corporate veil” argument where an entity attempts to deny its own separate existence.¹⁰⁸ The court rejected this argument and held the subsidiary liable although the basis seems to have been estoppel. The subsidiary had its own president and directors and submitted annual statements. The Supreme Court held that the subsidiary thus created the impression that it was a separate entity which it could not then deny.¹⁰⁹

From the outset the attitude of the courts towards limited liability in groups was inconsistent. There are cases where the courts confirmed the separate personality of the subsidiary and refused to hold the holding company liable for the delicts committed by its subsidiary or *vice versa*.¹¹⁰ In *Pennsylvania Company v Esther Rossett*¹¹¹ Rossett was injured on the Pittsburg, Cincinnati, Chicago & St Louis Railway Co railway. The question that the court had to decide was whether the appellant holding company managed and controlled the railway to incur liability for its possible negligence. On the facts the court accepted that although the holding company held all the shares in the relevant railway company that this could not imply delictual liability. The court

¹⁰⁸ *Blumberg Corporation Law* 69

¹⁰⁹ 40.

¹¹⁰ In this regard see *Atchison, Topeka and Santa Fe Railroad Company v Cochran* 7 L.R.A. 414, 43 Kan. 225, 23 P. 151, 19 Am.St.Rep. 129 where the Supreme Court of Kansas refused to hold the defendant liable for damages for the death of Cochran. Cochran purchased a railway ticket from the subsidiary of the defendant, Southern Kansas Railroad which purchase caused a contract of carriage to be entered into. A train from the defendant company knocked Cochran down at the station where he needed to mount the train and he died from his injuries. The court held that the two companies were separate entities and could not be held liable for the negligence of each other. It was then a question of fact to determine which of the two companies was negligent in the case and caused the death of Cochran.

¹¹¹ *Pennsylvania Company v Esther Rossett* 116 Ill. App. 342, 1904 WL 2007 (Ill.App. 1 Dist).

nevertheless still held on the facts that the holding company and the relevant subsidiary were one entity and therefore held that the railway in question was under the control and management of the appellant.

In *Pennsylvania Railroad Company v Jones Same v Stewart* Nos 40 and 41¹¹² a number of companies were engaged in the transportation of passengers on various lines of which some intersected and on one of such intersecting lines an accident caused the death or injury of a number of persons. The injured therefore claimed damages from these companies as common carriers. The court held that the mere fact that the appellant held (the majority) shares in the other appellants did not imply that there was some partnership or agreement with those companies to act as a common carrier and there could therefore not be any liability purely on that basis.

In *Lehigh Valley Railroad Company v Dupont*,¹¹³ Dupont was the executor of the estate of Jules Dupont who died in a railroad accident. Lehigh was the holding company of the Easton & Amboy Railroad Company on whose railroad Dupont was killed. On the facts there was a strong argument that the subsidiary was the agent of the holding company since the carrier ticket, which the deceased bought, showed at face value that the carrier was Lehigh. This fact was sufficient for the court to hold Lehigh liable.

In *Lehigh Valley Railroad Company v Delachesa*¹¹⁴ an employee was injured on the railroad of the subsidiary of Lehigh. The question was whether the holding company, Lehigh, could be held liable for the injuries suffered. Although the court attempted to rationalise its judgment by referring to the facts of the case as justification it would appear that ultimately the mere fact that there existed a relationship of holding company and subsidiary between Lehigh and Easton & Amboy Railroad Company was sufficient to imply agency between them and therefore liability on the holding company.

¹¹² *Pennsylvania Railroad Company et al v Jones Same v Stewart* Nos 40 and 41 155 US 333, 15 S. Ct 136, 39 L.Ed 176.

¹¹³ *Lehigh Valley Railroad Company v Dupont* 128 F. 840, 64 C.C.A. 478.

¹¹⁴ *Lehigh Valley Railroad Company v Delachesa* 145 F. 617, 76 C.C.A. 307.

In *United States v Milwaukee Refrigerator Transit Co et al*,¹¹⁵ Milwaukee was accused of giving and receiving unlawful rebates. In terms of the Interstate Commerce Act of 1889¹¹⁶ common carriers, the officers of such common carriers, receivers and agents of such corporations were prohibited from giving rebates, preferences and advantages and making unjust discriminations and were punishable by fine and imprisonment. The carriers themselves were not punishable but only the agents of corporate carriers.

In terms of the Interstate Commerce Act of 1889 any common carrier, and the officers and agents of corporate carriers who by means of “false new acting, classification, weighing or other device or means, shall assist, suffer, or permit any one to obtain transportation at less than established rates, shall be guilty of a misdemeanor, punishable by fine and imprisonment.” According to the court the corporate carriers themselves did not fall within the ambit of the penalties.¹¹⁷ In terms of the Elkins Act of 1903 corporate carriers were made liable to the same extent as were their agents under the abovementioned two statutes but subject to a fine only.

In casu a brewer company was a large shipper of beer prior to the enactment of the Elkins Statute and habitually received rebates from carriers. After the enactment of the statute the defendant company was incorporated which contracted with the brewer company to make all shipments of the brewer company and the defendant contracted for shipments with such interstate carriers as would pay it from one tenth to one eighth of the published rate for the transportation, ostensibly as a commission for obtaining the business (which was allowed), but in fact was according to the charges a rebate for the benefit of the brewer company. The question before the court was therefore whether any repayments were made to the brewing company or to a third party. On the facts the court held that the two companies were one and the same and were guilty of the offences as charged. To a present-day company lawyer the outcome of this case, like the previous ones, would be surprising given the fact that the law allows a person to utilise such structures to avoid

¹¹⁵ *United States v Milwaukee Refrigerator Transit Co et al* 142 F. 247, 1 A.F.T.R 131.

¹¹⁶ S 10.

¹¹⁷ 249.

certain statutory rules especially in those cases where there is no fraudulent activity involved.

In *United States Ex Pel. Attorney General of the United States v Delaware & Hudson Company, Erie Railroad Company, Central Railroad Company of New Jersey, Delaware, Lackawanna & Western Railroad Company, Pennsylvania Railroad Company, Lehigh Valley Railroad Company*¹¹⁸ the issue at stake was once again the alleged transgression of certain commercial legislation. In terms of the Hepburn Act¹¹⁹ it was unlawful for railroad companies to transport, among others, coal in interstate commerce if the coal was manufactured, mined, or produced by it [the railroad company] or under its authority, or which it may own in whole or in part, or in which it may have any interest direct or indirect.” The accused companies therefore incorporated subsidiary companies to conduct the mining operations whereafter they would transport the mined articles. The United States alleged that the interest which a holding company had in a subsidiary would be embraced by the phrase “interest direct or indirect”. The accused, however, averred that the phrase “interest direct or indirect” included only those commodities in which the railroad companies had a legal interest and excluded the situation where the railroad company was the holding company of the mining company and the only interest it had was the shares which it held in the subsidiary.

The court approached the question from the point of departure that the legislature would have expressly provided for the holding company and subsidiary company situation had it been its intention to extend the prohibition to this situation. Since there was no express language to cover the situation at hand it must have been the intention of the legislature not to include the holding company–subsidiary company relationship under the prohibition.

¹¹⁸ *United States Ex Pel. Attorney General of the United States v Delaware & Hudson Company, Erie Railroad Company, Central Railroad Company of New Jersey, Delaware, Lackawanna & Western Railroad Company, Pennsylvania Railroad Company, Lehigh Valley Railroad Company* 213 U.S 366, 29 S.Ct. 527, 53 L.Ed 836.

¹¹⁹ Hepburn Act June 29, 1906, c. 3591, 34 Stat. 584, 49 U.S.C.A. §1.

In *United States of America v Lehigh Valley Railroad Company*,¹²⁰ the issue at stake was similar and once again the case concerned an alleged transgression of the Hepburn Act. Lehigh and others had incorporated subsidiary companies to conduct the mining operations and they would then transport the mined commodities. The United States alleged that the coal mining company was not a *bona fide* operation but merely an instrument of Lehigh which was the legal owner of the mining company and had a pecuniary interest in the coal which was mined by the subsidiary.

The court held that the facts showed that the railroad company had actual control over the property of the subsidiary and an actual interest in that property which went beyond the mere interest which the railroad company would have had as a shareholder. The court therefore held the two entities to be one. The court furthermore rejected the argument that the legislature had to use express language to include the holding company–subsidiary company situation. The court held that the wording of the statute was clear enough to include the situation at hand. It furthermore held that:

“[I]n view of the express prohibitions of the commodities clause, it must be held that while the right of a railroad company as stockholder to use its stock ownership for the purpose of a bona fide separate administration of the affairs of a corporation in which it has a stock interest may not be denied, the use of such stock ownership in substance for the purpose of destroying the entity of a producing, etc, corporation, and of commingling its affairs in administration with the affairs of the railroad company, so as to make the two corporations virtually one, brings the railroad company so voluntarily acting as to such producing, etc, corporation within the prohibitions of the commodities clause.”¹²¹

In *Augusta A Peterson and Ida Peterson, a Minor v Chicago, Rock Island & Pacific Railroad Company*,¹²² the defendant company had a subsidiary company in Texas, namely the Chicago, Rock Island & Gulf Railroad. The plaintiffs sued the defendant based on the alleged negligent killing of their husband/father who was employed by the Texan company. The plaintiffs alleged that the Texan company was the subsidiary of the

¹²⁰ *United States of America v Lehigh Valley Railroad Company* 220 U.S 257, 31 S.Ct. 387, 55 L.Ed 458, 3 A.F.T.R 2855.

¹²¹ 274, 391.

¹²² *Augusta A Peterson and Ida Peterson, a Minor v Chicago, Rock Island & Pacific Railroad Company* 205 U.S 364, 27 S.Ct. 513, 51 L.Ed 841, 3 A.F.T.R. 2794.

defendant and thus the principal was liable for damages. The court held that the mere fact that the defendant held the majority shareholding in the Texan company did not make it the principal of the Texan company and therefore the argument that the defendant conducted business in Texas through its subsidiary could not be sustained.¹²³

In *Stone et al v Cleveland, Cincinnati, Chicago & St. Louis Railroad Co et al*¹²⁴ the New York Court of Appeal gave a well reasoned judgment as to why a holding company could not be held liable for the damages caused by the negligence of a subsidiary merely because it was the major shareholder in the subsidiary.

The New York Court of Appeals considered the fact that the appellant owned the majority of shares in the offending railroad company which enabled it to control the appointment or dismissal of directors. A minority of the directors of the offending subsidiary were also directors of the appellant. The same applied to a number of executive officers. The court mentioned that the question to be decided was whether the evidence made one railroad company responsible for the ordinary daily operations of its subsidiary where the corporate organisation of the subsidiary was controlled by the holding company although the two companies remained distinct and separate legal entities. The court held that where the subsidiary maintained a separate corporate identity, entered into its own contracts, kept its own accounts, collected its own income and paid its own operating expenses and the only interest which the holding company had in the subsidiary was the financial interest of possible dividends, the holding company could not be held liable for the operations of the subsidiary.¹²⁵

The New York Court of Appeal referred to *Pennsylvania Railroad Company v Jones Same v Stewart* Nos 40 and 41¹²⁶ and *Augusta A Peterson and Ida Peterson, a Minor v*

¹²³ 391 and 393.

¹²⁴ *Stone et al v Cleveland, Cincinnati, Chicago & St. Louis Railroad Co et al* 202 N.Y. 352, 95 N.E 816.

¹²⁵ 356–357.

¹²⁶ *Pennsylvania Railroad Company et al v Jones Same v Stewart* Nos 40 and 41 155 US 333, 15 S. Ct 136, 39 L.Ed 176.

*Chicago, Rock Island & Pacific Railroad Company*¹²⁷ but distinguished the facts of those two cases from the factual situation *in casu*. What is clear from the judgment of the New York Court of Appeals is the fact that it refused to hold the holding company liable for the delict of the subsidiary merely because the holding company exercised control over the subsidiary.

In *United States v Reading Co and others*¹²⁸ the United States Supreme Court had to decide mainly on the alleged contravention of the applicable anti-trust legislation by Reading Co and a number of its subsidiaries in the coal mining and transportation businesses. A secondary question to be decided was the alleged contravention by some of the subsidiaries of Reading Co of the commodities clause.¹²⁹

The Supreme Court investigated the history of the acquisition by the holding company of the various subsidiaries as well as looking at the evidence at hand. It was clear to the court that there was collusion between the holding company and its subsidiaries to prevent competition. The question was whether the mere control of a holding company was sufficient to hold it liable under the anti-trust legislation. The court referred to *Northern Securities Co v United States*¹³⁰ and quoted the following passage from that case:

“No scheme or device could certainly come within the words of the act - ‘combination in the form of a trust or otherwise in restraint of commerce among several states or with foreign nations’- or could more effectively and certainly suppress free competition between the constituent companies. The mere existence of such a combination and the power acquired by the holding company as its trustee, constitute a menace to, and a restraint upon, that freedom of commerce which Congress intended to recognize and protect, and which the public is entitled to have protected.”¹³¹

The Supreme Court also referred to another of its own previous decisions in *United States v Union Pacific Railroad Company*¹³² where it held that:

¹²⁷ *Augusta A Peterson and Ida Peterson, a Minor v Chicago, Rock Island & Pacific Railroad Company* 205 U.S 364, 27 S.Ct. 513, 51 L.Ed 841, 3 A.F.T.R. 2794.

¹²⁸ *United States v Reading Co and others* 253 U.S 26, 40 S. Ct. 425, 64 L.Ed. 760, 3 A.F.T.R 3067.

¹²⁹ See above the cases discussed in respect of the commodities clause.

¹³⁰ 193 U.S. 197, 24 S.Ct. 436, 48 L.Ed. 679 (1903).

¹³¹ 58.

¹³² *United States v Union Pacific Railroad Company* 226 U.S 61, 88, 33 Sup. Ct 53, 58 (57 L. Ed 124).

“the consolidation of two great competing systems of railroad engaged in interstate commerce by transfer to one of a dominating stock interest in the other creates a combination which restrains interstate commerce within the meaning of the statute, because, in destroying or greatly abridging the free operation of competition theretofore existing, it tends to higher rates. Nor does it make any difference that rates for the time being may not be raised and much money be spent in improvements after the combination is effected. It is the scope of such combinations and their power to suppress or stifle competition or create monopoly which determines the applicability of the Act.”¹³³

The court therefore held that there was a contravention of the anti-trust legislation and ordered the break up of the group with each company required to be independent and free from shareholding or other control by the other companies.

In *Berkey v Third Avenue Railway Company*¹³⁴ which was decided in 1926, the New York Court of Appeals had to decide on the liability of a holding company for the delictual damages that its subsidiary caused. The plaintiff in this case was injured through the negligence of the motorman of the Forty Second Street, Manhattanville & Saint Nicholas Avenue Railway Company which company’s shares were substantially held by the respondent. The basis of the action by the plaintiff was that the respondent operated the whole railway system of its subsidiaries, including the one in question, under the screen of subsidiaries and that the respondent was therefore liable for the delicts of the consolidated enterprise.¹³⁵ After analysing the facts of the matter the Court of Appeal held that the corporate veil will be pierced where the subsidiary is a mere dummy of the holding company. The court mentions a number of factors where piercing would be allowed without exactly stating what the basis for the decision was in the case at hand. It referred to a “dummy”, public policy, “tests of honesty and justice”, the subsidiary having no independent existence, fraud and abuse. It would appear that any of these would suffice as seen from the extract below:

“Liability of the parent has never been adjudged when the subsidiary has maintained so consistently and in so many ways as here the separate organization that is the mark of a separate existence. [...] The whole problem of the relationship between parent and subsidiary corporations

¹³³ 58.

¹³⁴ *Berkey v Third Avenue Railway Company* 244 N.Y 84, 155 N.E 58, 50 A.L.R 599 (1926).

¹³⁵ 87.

is one that is still enveloped in the mists of metaphor. Metaphors in law are to be narrowly watched, for starting as devices to liberate thought, they end often by enslaving it. We say at times that the corporate entity will be ignored when the parent corporation operates a business through a subsidiary which is characterised as an ‘alias’ or ‘dummy.’ All this is well enough if the picturesqueness of the epithets does not lead us to forget that the essential term to be defined is the act of operation. Dominion may be so complete, interference so obtrusive, that by the general rules of agency the parent will be principal and the subsidiary an agent. Where control is less than this, we are remitted to the tests of honesty and justice. [...] The logical consistency of a juridical conception will indeed be sacrificed at times, when the sacrifice is essential to the end that some accepted public policy may be defended or upheld. This is so, for illustration, though any agency in any proper sense is lacking, where the attempted separation between parent and subsidiary will work a fraud on the law. [...] At such times unity is ascribed to parts which, at least for many purposes, retain an independent life, for the reason that only thus can we overcome a perversion of a privilege to do business in a corporate form. We find in the case at hand neither agency on the one hand, nor, on the other, abuse to be corrected by the implication of a merger.¹³⁶

In *Cannon Manufacturing Company v Cudahy Packing Company*,¹³⁷ Cannon was a company which was incorporated in North Carolina. Cannon instituted legal action in North Carolina against Cudahy, which was incorporated in Maine, for breach of contract. Cudahy brought a point *in limine* in the North Carolina court that the North Carolina court had no jurisdiction over it since Cudahy did not conduct business in North Carolina. The summons in the action was served on the subsidiary of Cudahy, Cudahy Packing Company of Alabama, which had an office in North Carolina. Cannon therefore had to show that Cudahy in fact conducted business in North Carolina.

The Alabama company did not act as the agent of Cudahy. It bought products from Cudahy and sold them to dealers. The sold products were, however, delivered directly by Cudahy to the dealers and the Alabama company collected the purchase price. On the other hand the two companies operated as two distinct legal entities by keeping separate books and the transactions between the companies were also reflected like any transactions between two independent entities.

¹³⁶ 94–95.

¹³⁷ *Cannon Manufacturing Company v Cudahy Packing Company* 267 U.S. 333, 45 S.Ct. 250, 69 L.Ed. 634 (1925).

The Supreme Court considered the arguments and cases like *Peterson v Chicago, Rock Island & Pacific Railway Company*,¹³⁸ discussed above, and affirmed that the mere fact that a holding company had a subsidiary in another state did not necessarily subject the holding company to the jurisdiction of that state.¹³⁹ The court eventually held that the separation of the two Cudahy companies was real and not a fiction. There was therefore no basis to hold that the business of Cudahy Alabama in North Carolina became the business of Cudahy Packing Company.

In the same year that it decided the *Cudahy* case, the Supreme Court had to decide the *Davis v Alexander*¹⁴⁰ case. In this case cattle, which were being transported from New Mexico, through Texas, to Oklahoma on the Chicago, Rock Island & Pacific Railway System, were negligently injured during federal control. The action to recover damages was instituted in the state court of Oklahoma against Davis, in his capacity as agent designated by the President, pursuant to the Transportation Act of 1920.¹⁴¹ The injuries which were suffered by the cattle were suffered partly in New Mexico, partly in Texas and partly in Oklahoma. The main issue to be decided was whether the claim for the injuries in Texas should be allowed.

The main issue arose because the railway lines of the Rock Island System in Texas were owned by a subsidiary, the Chicago, Rock Island & Gulf Railway Company which was incorporated in Texas. Davis was in charge of both the holding and the subsidiary company. The holding company argued that the companies operated the two railway systems as independent and distinct systems and entities. The court, apparently referring to the facts before it, held that “where one railroad company actually controls another and operates both as a single system, the dominant company will be liable for injuries due to

¹³⁸ 205 U.S. 364, 27 S.Ct. 513, 51 L.Ed. 841, 3 A.F.T.R. 2794.

¹³⁹ *Cannon Manufacturing Company v Cudahy Packing Company* 336 where the court also refers to *Conley v Mathieson Alkali Works*, 190 U.S. 406, 409-411, 23 S.Ct. 728, 47 L.Ed. and *People's Tobacco Co Ltd v American Tobacco Company Co* 246 U.S. 79, 87, 38 S. Ct. 233, 62 L.Ed. 587, Ann. Cas. 1918 C, 537.

¹⁴⁰ *Davis v Alexander* 269 U.S. 114, 46 S.Ct. 34, 70 L.Ed. 186 (1925).

¹⁴¹ Sec 206(a) of Transportation Act February 28, 1920, c. 91, 41 Stat. 456, 461 (Comp. St. Ann. Supp. 1923, s 10071 1/4 cc).

the negligence of the subsidiary company.”¹⁴² The claim for the injuries in Texas was therefore successful.

The Interstate Commerce Act¹⁴³ again came before the Supreme Court in *United States v Elgin, Joliet & Eastern Railway Company*.¹⁴⁴ It would appear that by this stage the courts had accepted that a company may hold the majority shares in a producing company and then also transport the latter’s products without violating the Interstate Commerce Act.¹⁴⁵ In the *Elgin* case, however, the holding company held the majority shares in both the producing and the transportation company. The State argued that such transportation is illegal. The argument was that the subsidiaries of a holding company were no more than parts of the holding company.

The court then stated that “it is impossible for us now to declare as matter of law that every company all of whose shares are owned by a holding company necessarily becomes an agent, instrumentality, or department of the latter. Whether such intimate relation exists is a question of fact to be determined upon evidence.”¹⁴⁶ The court furthermore held that “[t]he mere power to control, the possibility of initiating unlawful conditions, is not enough. [...] That a stockholder should show concern about the company’s affairs, ask for reports, sometimes consult with its officers, give advice, and even object to proposed action is but the natural outcome of a relationship not inhibited by the commodities clause.”¹⁴⁷

From the above it would appear that the early United States’ cases in general did not easily depart from the principle of limited liability. The courts were only willing to pierce the corporate veil in a few cases which either dealt with competition law where other policy considerations weigh stronger than limited liability or in cases where there were

¹⁴² *Davis v Alexander* 117 with reference to *Lehigh Valley Railroad Company v Dupont* , 128 F 840, 64 C. C.A 478; *Lehigh Valley Railroad Company v Delachesa*, 145 F 617, 76 C.C.A 307 and *Wichita Falls & Northwestern Railway Company v Puckett*, Okl. 463, 157 P. 112.

¹⁴³ Interstate Commerce Act of 1889.

¹⁴⁴ *United States v Elgin, Joliet & Eastern Railway Company* 298 U.S. 492, 56 S. Ct. 841, 80 L. Ed. 1300.

¹⁴⁵ See cases cited and discussed above regarding the Interstate Commerce Act, for example the *Milwaukee Refrigerator* case.

¹⁴⁶ *United States v Elgin, Joliet & Eastern Railway Company* 501.

¹⁴⁷ *United States v Elgin, Joliet & Eastern Railway Company* 503–504.

cogent reasons to pierce the veil. It therefore becomes necessary to investigate the development of the piercing of the corporate veil doctrine in the United States in more detail, which will be done in a subsequent chapter.¹⁴⁸

2.3 Limited liability from an economic perspective

The importance of limited liability from an economic perspective has been emphasised in the following terms

“The economic historian of the future may assign to the nameless inventor of the principle of limited liability ... a place of honour with Watt and Stephenson and other pioneers of the Industrial Revolution. The genius of these men produced the means by which man’s command of natural resources was multiplied many times over; the limited liability company the means by which huge aggregations of capital required to give effect to their discoveries were collected, organized and efficiently administered.”¹⁴⁹

A company has voluntary creditors in the form of trade creditors and employees. It may also have involuntary creditors in the form of people who have claims based in delict against the company. Voluntary creditors run the risk of non-payment when they extend credit to a company as is the case when they extend credit to a natural person. The higher the risk and the longer the risk will be present, the more these creditors will attempt to safeguard themselves, either in the form of higher interest rates or a demand for security, or both.

Cheffins¹⁵⁰ argues that limited liability has a positive effect on people who are “poor risk bearers”.¹⁵¹ A poor risk bearer is a person who may or may not be wealthy but whose assets would be exposed to attachment to satisfy the debts of a company. Such liability could ruin the investor financially. Limited liability shifts this risk from a poor risk bearer to creditors who are more than likely better equipped to deal with the insolvency of its debtor company.¹⁵²

¹⁴⁸ See para 6.2.1 below.

¹⁴⁹ The *Economist* dated 18 December 1926 as quoted by Halpern, Trebilcock & Turnbull “*An Economic Analysis*” 118.

¹⁵⁰ Cheffins *Company Law: Theory, Structure and Operation* (1997).

¹⁵¹ Cheffins *Company Law* 500.

¹⁵² Cheffins *Company Law* 500.

Easterbrook and Fischel¹⁵³ advance a number of reasons justifying limited liability from an economic perspective. Firstly, limited liability reduces the costs involved for shareholders to monitor the people who manage the company, the board of directors.¹⁵⁴ The board of directors acts as representative or agent of the company. The ideal solution would naturally be that each shareholder would like to monitor the conduct of the business as closely as possible. This is however unrealistic. The profile of the individual shareholder in the modern world is mostly an educated person who is meaningfully employed and who does not have the time to monitor constantly the people who manage the company in which he or she holds shares. The chances are also good that the shareholder may hold shares in a number of companies which further reduces the chances of (effectively) monitoring the directors of those companies. Even if the shareholder appoints fund managers to invest in companies on his behalf the monitoring of company managements will still be difficult. Easterbrook and Fischel argue that at some point the costs of monitoring would be disproportionate to the investment of the shareholder. They argue that in the light of the possible diversified nature of the portfolio of a shareholder, the shareholder will neither have the incentive nor the necessary expertise to monitor the conduct of the directors of a company who are, in theory, experts in what they are doing.¹⁵⁵

The second economic advantage of limited liability is that it reduces the costs involved to monitor the other shareholders of the company. If limited liability did not exist, there would be lower risk that the estate of any one shareholder would be required to satisfy a corporate debt where the estates of other shareholders are larger than the estate of that shareholder. In such a case it would make sense for shareholders to monitor the activities of the other shareholders to guard against them disposing of their assets, although the monitoring costs would be high. Limited liability however makes this exercise unnecessary and the identity and relative wealth of these shareholders irrelevant.¹⁵⁶

¹⁵³ Easterbrook & Fischel *The economic structure of corporate law* (1991).

¹⁵⁴ Easterbrook & Fischel *Economic structure* 41.

¹⁵⁵ Easterbrook & Fischel *Economic structure* 41-42.

¹⁵⁶ Hansman & Kraakman "The Essential Role of Organizational Law" (2000) *Yale Law Journal* 110 387 424.

The third advantage of limited liability is that it promotes efficient management. Limited liability in practice promotes the transferability of shares. Since shareholders are generally free to dispose of their shareholding, this restrains the actions of the board of directors. The restraint is provided by the voting rights which are tied to the shareholding. If existing shareholders were to sell their shares, the new shareholders could form powerful blocks and remove inefficient directors. The directors who therefore act under the sword of being removed by shareholders will act efficiently to avoid the threat of dismissal.¹⁵⁷

The fourth benefit of limited liability is the shifting of monitoring from the shareholders to the creditors of the company.¹⁵⁸ The reason for this is obvious. If creditors know that they will only have recourse against the assets of the company, they will monitor those assets and the company with more vigour than in the case where shareholders have unlimited liability.

The fifth advantage of limited liability is that it creates a uniform share price in light of the fact that the value of the shares of the company reflects any further information of the company.¹⁵⁹ Unlimited liability would create a situation where shares would not be homogenous commodities and the market price for the shares would vary from shareholder to shareholder due to the fact that a person who wants to invest in a company would have to incur greater costs to determine whether the value of the shares of the company is its true value. Potential shareholders would therefore incur greater costs to determine the true value of the shares which then reduces their appetite to invest. If everybody buys and sells on the same terms the market will reflect the true value of the shares based on the available information in respect of the company at hand. The need to engage in costly research for information therefore falls away.¹⁶⁰

¹⁵⁷ Easterbrook & Fischel *Economic structure* 42.

¹⁵⁸ Hansman & Kaarkman *Organizational Law* 425.

¹⁵⁹ Easterbrook & Fischel *Economic structure* 43.

¹⁶⁰ Easterbrook & Fischel *Economic structure* 43. See also Cheffins *Company Law* 499.

Sixthly, limited liability stimulates the diversification of the share portfolio of an investor.¹⁶¹ Since his only risk is the investment that he has made, he has the incentive to diversify his share portfolio by buying shares in a number of diverse companies. Were he exposed to unlimited liability such a diversification would become an extremely high risk. The reason is that he would expose his estate to claims by creditors of a number of companies whereas investment in one company would reduce the risk to only that one company. A company can therefore seek investors at a lower cost due to limited liability, since the investor knows that the loss of his investment is the only risk. Under unlimited liability an investor would not diversify and this would increase the costs to companies of raising funds.¹⁶²

The last reason for limited liability is connected to the fifth reason. Limited liability promotes the diversification of an investor's share portfolio because a shareholder would want to invest in a company which is growing, without fear of liability should the company fail. If the company fails this is not fatal, since the shareholder's risk was limited to his investment and he has also been able to diversify his portfolio by holding shares in other companies. With unlimited liability this would not be possible. If a business venture is risky, despite the present growth value of a company's shares, a potential shareholder would not want to enter into the risk of diversification. Easterbrook and Fischel argue that this is a social loss because business ventures which show a positive net present value¹⁶³ are "beneficial uses of capital".¹⁶⁴

In summary therefore limited liability reduces the financing costs of business ventures by reducing the time and costs spent to obtain and disseminate information about a company and its activities, the conduct of its management as well as the monitoring of the other shareholders of the company. This leads to more efficient business structures as well as

¹⁶¹ Easterbrook & Fischel *Economic structure* 43.

¹⁶² Easterbrook & Fischel *Economic structure* 43. See also Cheffins *Company Law* 499.

¹⁶³ Although the authors do not define the term it could be described, considering the context in which it appears, as the probability of success or failure of a business venture in relation to financial reward or loss. In cases therefore of unlimited liability an investor would not invest where there is a greater chance of failure regardless of the high possible return on the investment.

¹⁶⁴ Easterbrook & Fischel *Economic structure* 44.

the standardising of credit terms which creditors are willing to provide to corporate debtors.¹⁶⁵ Anderson, however, argues that the economic efficiency arguments of neoclassical economists are based on the assumption that all the relevant information is available to the market which the market is able to digest as it becomes available.¹⁶⁶ This is of course not so. Various creditors have different abilities to obtain information. The stronger the bargaining power of a creditor, a bank for example, the more it can protect itself, bearing in mind its ability to access this information. A small creditor does not have this power. Cheffins argues that in cases of abuse of limited liability or where management mismanages the company a creditor could advance credit to a company without being aware of such abuse and cannot contractually adjust the risk which he is exposed to. The losses which he suffers could impact on the funds he has available for other productive uses, which losses may then have a social impact.¹⁶⁷

The economic arguments justifying limited liability should, however, be viewed with circumspection. Limited liability may make economic sense in contract law but it does not necessarily make sense in the context of the law of delict, or where a group of companies is involved.¹⁶⁸ Cheffins also expresses the same concerns about limited liability in the field of delictual law including the costs involved for an individual who had to institute legal action against shareholders who could be spread across the world.¹⁶⁹

2.4 Limited liability from a legal perspective

Antunes argues that limited liability should be viewed from the point of view that there should be some form of power before a person can be saddled with liability; no liability without power.¹⁷⁰ Since shareholders have no power because it is vested in the board of directors, the argument proceeds that there cannot be liability for the shareholders. Antunes then argues that in a corporate group the situation is different in that there is a

¹⁶⁵ Adams *Ökonomische Theorie des Rechts Konzepte und Anwendungen* 2ed (2004) 243.

¹⁶⁶ Anderson "Creditors Rights of Recovery: Economic Theory, Corporate Jurisprudence and the Role of Fairness" (2006) *Melbourne University Law Review* 30 1 8.

¹⁶⁷ Cheffins *Company Law* 504.

¹⁶⁸ See paras 2.5, 2.6 and 6.4 below.

¹⁶⁹ Cheffins *Company Law* 506-507.

¹⁷⁰ Antunes *Liability of Corporate Groups: Autonomy and Control in Parent-Subsidiary Relationships in US, German and EU Law: An International and Comparative Perspective* (1994) 131.

dominant shareholder who exercises all the power over the subsidiaries, hence there should be some form of liability.¹⁷¹

This argument of Antunes is not without merit but it is an open question whether it can be supported. Shareholders are not completely without power. It may be correct that if they are in the minority that the only power that they may have is the ability to prevent a special resolution but they are certainly not without power. If the argument is that they do not enjoy effective power the argument could have some basis. But the counterargument would then be that the directors, who enjoy the power, should be saddled with liability. This is not reflected in the current company laws of any major jurisdiction.

A legal discussion of limited liability is not possible without making reference to the House of Lords' decision in *Salomon v Salomon & Co Ltd*.¹⁷² Mr Salomon was a boot and shoe manufacturer who sold his business to a company which he incorporated. Seven shareholders were required by the Companies Act.¹⁷³ The shareholders were Mr Salomon, who owned the majority of the shares, which he received as part payment for the sale of the business to the newly incorporated company, and the rest of his family, bar one, each holding one share in the company. The purchase price for the business of Mr Salomon was partially to be paid by means of debentures which the company issued to Mr Salomon and which provided him with security for the debt as well as preference over the concurrent creditors of the company.

At the time of the transfer of the business to the company the business was a prosperous and solvent one. In less than a year the company became insolvent. Salomon borrowed money and provided the debentures in the company as security to the lender. Salomon however retained a beneficial interest in the debentures which provided him with a preferent claim against the company. Upon the liquidation of the company the liquidator attempted to have the preference of Mr Salomon set aside. The court of first instance refused this but instead was of the opinion that Mr Salomon should be held liable for the

¹⁷¹ Antunes *Liability of Corporate Groups* 132.

¹⁷² [1897] A.C. 22 [H.L.].

¹⁷³ Companies Act of 1862.

debts of the company since the company was a mere alias for Mr Salomon. On appeal the Court of Appeal held that the incorporation of the company was contrary to the intention of the Companies Act and that the company was merely a trustee of Mr Salomon who acted as a *cestui que trust*. Furthermore the court held that the family member shareholders were mere dummies of Mr Salomon and that the incorporation of the company and the transfer of the business of Mr Salomon to the company was a scheme which was contrary to the intention of the legislature.

The House of Lords unanimously rejected the decisions of the Court of Appeal and the court of first instance. Lord Macnaghten focused on the requirements of the Companies Act which provides for separate juristic personality upon incorporation.¹⁷⁴ The House of Lords provided the reason why an investor would incorporate a company, namely to avoid liability which was the purpose behind the Companies Act. *In casu* there was no fraud or dishonesty on the part of Mr Salomon. The unsecured creditors, in the words of Lord Macnaghten “had only themselves to blame for their misfortunes. They had full notice that they were no longer dealing with an individual, and they must be taken to have been cognisant of the memorandum and of the articles of association.”¹⁷⁵ Ultimately the court was swayed by the fact that Mr Salomon merely did what the law allowed him to do. This decision set the tone for more than a century and is still the prevalent view.

2.5 An apparent alternative perspective on limited liability

Hansmann and Kraakman¹⁷⁶ argue that the essential role of organisational law¹⁷⁷ is

“to provide for the creation of a pattern of creditors - a form of ‘asset partitioning’ - that could not be practicably established otherwise. One aspect of this asset partitioning is the delimitation of the extent to which creditors of an entity can have recourse against the personal assets of the owners [...] of the entity. The truly essential aspect of asset partitioning is, in effect, the reverse of limited liability - namely, the shielding of the assets of the entity from claims of the creditors of the entity’s owners or managers.”¹⁷⁸

¹⁷⁴ 51. “The company attains maturity at its birth. There is no period of minority – no interval of incapacity.”

¹⁷⁵ 53.

¹⁷⁶ Hansmann & Kraakman *Organizational Law* 390.

¹⁷⁷ The law in respect of different legal entities.

¹⁷⁸ Hansmann & Kraakman *Organizational Law* 390.

Hansmann and Kraakman identify two crucial elements for a firm to serve as a nexus of contracts.¹⁷⁹ Firstly it has to have agents to enter into contracts on behalf of the entity and secondly the firm has to have a pool of assets to satisfy claims of creditors against the company.¹⁸⁰ The authors refer to this pool of assets as the firm's "bonding assets."¹⁸¹

A natural person has these two attributes. Juristic persons also have these attributes but differ from natural persons in that their bonding assets are separate from the assets of the shareholders or directors of the company. Therefore the creditors of the juristic person can in principle only claim from the assets of the juristic person and the creditors of the shareholders and directors of the company can only claim from the personal assets of the shareholders and directors respectively. For Hansmann and Kraakman the last mentioned element is the defining element of a juristic person, i.e. the separation of the bonding assets of the entity and the personal assets of the shareholders and directors of the juristic person.¹⁸² Organisational law's most important role according to the authors is then to establish this separation of assets.¹⁸³

Asset partitioning has two components. The first is to separate the assets of the juristic entity and the shareholders of the juristic entity. The second component is the "assignment to creditors of priorities in the distinct pools of assets that result from the formation of a legal entity."¹⁸⁴ This assignment of assets then takes two forms. The first is the claim that the creditors of the company have against the assets of the company which ranks higher and stronger than the claim of the creditors of the shareholders of the company. This the authors call "affirmative asset partitioning."¹⁸⁵ The other form of asset partitioning is called defensive asset partitioning. This term reflects the opposite notion, namely that the personal creditors of the shareholders have a prior claim against the personal assets of the shareholders of a company, which claim is stronger than the claims,

¹⁷⁹Cheffins *Company Law* 32 states that a company is a "network of explicit and implicit bargains, or a nexus of contracts" according to contractual theorists . See chapter three in respect of the nexus of contracts argument.

¹⁸⁰ Hansmann & Kraakman *Organizational Law* 392.

¹⁸¹ Hansmann & Kraakman *Organizational Law* 392.

¹⁸² Hansmann & Kraakman *Organizational Law* 393.

¹⁸³ Hansmann & Kraakman *Organizational Law* 393.

¹⁸⁴ Hansmann & Kraakman *Organizational Law* 393.

¹⁸⁵ Hansmann & Kraakman *Organizational Law* 393.

if any, of the voluntary creditors of the company.¹⁸⁶ Defensive asset partitioning is therefore reflected by the principle of limited liability which precludes the creditors of a company from claiming against the assets of the shareholders of the company.¹⁸⁷ Affirmative asset partitioning and defensive asset partitioning form two sides of the same coin, the position of creditors of the company *vis-à-vis* the shareholders of the company and their personal creditors. Hansmann and Kraakman argue that affirmative asset partitioning reduces the costs of credit for companies since it reduces monitoring costs, it protects against the premature liquidation of assets and it allows for efficient risk allocation.¹⁸⁸

Hansmann and Kraakman argue that the costs of defensive asset partitioning are not high from the perspective of the shareholder. The reasons for this is that it allows the shareholders to act opportunistically towards the creditors of the company especially in cases where the asset value of the company is less than the credit which the company requires for its operations. This implies that the company may take excessive risks.¹⁸⁹

Hansmann and Kraakman next ask the question whether the law is required to provide for limited liability or whether it can be achieved by means of contract. The authors argue that although there could be high transaction costs involved for the shareholders, the latter approach would not be impossible. They argue that the transaction costs of establishing defensive asset partitioning would still not be as high as the transaction costs involved in creating affirmative asset partitioning.¹⁹⁰ Affirmative asset partitioning would be impossible to provide for by means of contract in light of the transaction costs, monitoring costs and moral hazard involved. The reasons for the high costs would be that the creditors of the company would have to rely on the shareholder to enter into a contract with each of his creditors that they would not lay claim to the assets of the company. The shareholder would have to enter into such a contract with every creditor

¹⁸⁶ Hansmann & Kraakman *Organizational Law* 393.

¹⁸⁷ Hansmann & Kraakman *Organizational Law* 394.

¹⁸⁸ Hansmann & Kraakman *Organizational Law* 398–405. Compare also Easterbrook & Fischel *Economic structure* para 2.3 51.

¹⁸⁹ Hansmann & Kraakman *Organizational Law* 423.

¹⁹⁰ Hansmann & Kraakman *Organizational Law* 429. In respect of affirmative asset partitioning by means of contract and the difficulties and resulting transaction costs see 406–410.

which would be time consuming and expensive. The monitoring costs for the creditors of the company would be excessive. They would have to monitor the shareholder to ensure that he enters into these contracts with every personal creditor. Since this will be difficult, this could lead to opportunistic behaviour by the shareholder by not contracting with all of his personal shareholders. This leads to moral hazard.¹⁹¹ With defensive asset partitioning the company, in the absence of limited liability, would include a standard waiver in every contract with a creditor in terms of which the creditor waives his right to claim from the personal estates of the shareholders. Hansman and Kraakman argue that these costs would not be as expensive as with affirmative asset partitioning since there would be no need to amend the contract in respect of every creditor (only one standard form waiver is required) and the chances for moral hazard would not be present.¹⁹²

In respect of involuntary creditors¹⁹³ the authors argue that limited liability would appear to be a “historical accident.”¹⁹⁴ They base this opinion on the circumstances which existed during the formative years of companies in the late nineteenth century where delictual liability was sufficient to cause the downfall of a company. The authors further argue that although limited liability makes sense in respect of the law of contract, it does not make sense in respect of delictual liability. A victim of a delict, after all, has no influence over who injures him. They therefore argue that “to make the amount recovered by a tort victim depend upon the legal form of the organization responsible for the tort is to permit the externalization of accident costs, and indeed to invite the choice of legal entity to be governed in important part by the desire to seek such externalization.”¹⁹⁵

The problem with the abovementioned views of Hansmann and Kraakman, in respect of voluntary creditors, is that they do not necessarily make sense within the context of the reality of a group of companies. The authors argue that asset partitioning benefits the creditors of the owners or managers of a company because the creditors of the owner

¹⁹¹ Hansmann & Kraakman *Organizational Law* 406-410. Where there is a number of shareholders the costs would increase exponentially.

¹⁹² Hansmann & Kraakman *Organizational Law* 429.

¹⁹³ An involuntary creditor is a creditor who involuntarily becomes a creditor of a company, for example, a delictual victim. A contractual creditor will therefore be a voluntary creditor.

¹⁹⁴ Hansmann & Kraakman *Organizational Law* 431.

¹⁹⁵ Hansmann & Kraakman *Organizational Law* 431.

enjoy protection for their claims against the owner in light of the fact that the creditors of the company cannot enforce claims against the owner. The problem with this argument where a holding company is the owner is that the owner does not have “personal creditors” and is even less in need of protection than the creditors of its subsidiary company in the light of the domination and control that the holding company enjoys. The holding company’s power to give directions to the subsidiary, divert corporate opportunities from the subsidiary to the holding company and deprive it of its funds ensures that the holding company runs less risk of insolvency than the subsidiary company. The creditors of the holding company are therefore shielded and were the holding company to be liquidated they have a claim against the assets of the holding company, which assets include its shares in the subsidiary company. The pool from which the creditors of the holding company can draw is in theory much bigger than the pool available to the creditors of the subsidiary and asset partitioning works in favour of the creditors of the holding company as well as the owners of the holding company. Should these owners be natural persons the ultimate benefits of the subsidiary company accrue to them and their creditors ultimately enjoy the benefits of limited liability and asset partitioning.

In chapter six it will be shown that other writers also doubt the historical basis for limited liability in respect of the field of the law of delict.¹⁹⁶

2.6 Evaluation

It is clear that limited liability was a concession by the state to enable companies to attract investors without the risk of these investors being liable for the company’s debts should the business venture fail or other liabilities arise. However, the doctrine of limited liability was adopted at a time when companies consisted of individual shareholders who were natural persons. As shown above legislators in the United States of America only allowed companies to hold shares in other companies in the 1880s and the judiciary also refused to recognise companies as shareholders unless their memoranda of association allowed this. Furthermore it should be borne in mind that after the Industrial Revolution

¹⁹⁶ Chapter 6, paras 6.4 and 6.5 below.

and the advent of companies, companies were small consisting of only a few investors. With the advancement in technology and growing economies it would only be natural to assume that companies would grow from businesses with a small number of investors to larger entities with more complex structures to deal with the expansion of their enterprises. An example is provided by the evolution of corporate structures to finance the building of railroads in the United States. Companies grew from being part of “atomic capitalism” to a system where groups of companies became the face of the economy.¹⁹⁷ When the doctrine of limited liability was adopted, the growth and sophistication of corporate business activities could not have been foreseen. This argument is strengthened by the fact that shareholding in companies was initially restricted in the United States to natural persons. The legislature had to intervene to enable shareholding by companies in other companies. Even when corporate shareholding was allowed the judiciary set strict requirements before a company could hold shares in another. Parallel to shareholding by a shareholder is the privilege of limited liability, namely that he will not be held liable for the debts of the company of which he is a shareholder. A conclusion which could reasonably be drawn from the above is that limited liability cannot be treated the same where a natural person is a shareholder in a company compared to the position of another company being a shareholder, since limited liability became the norm before companies could hold shares in other companies. Limited liability was merely an existing tool in company law which the judiciary and the legislature inadvertently extended to companies as shareholders without taking into account the context in which limited liability was adopted.

Limited liability evokes much discussion, as shown above. Its origins and the reasons for its existence differ from scholar to scholar. It is however clear from the historical perspective that it came about through a concession by the legislature and not by private contractual means. Companies were in existence long before limited liability was considered to be important for incorporators. Company groups were also not possible or even under consideration when the legislators in the United States granted limited liability to companies with natural person shareholders as shareholders. It is therefore an

¹⁹⁷ Antunes *Liability of Corporate Groups* 21-22.

open question whether the doctrine of limited liability provides adequate justification for not imposing some form of liability on holding companies in the light of the historical fact that holding companies and subsidiaries were not in existence or possible when the doctrine was introduced.

Interestingly, limited liability has not evoked much discussion in South African law and it is seemingly accepted as a logical consequence of the principle of a company being a separate juristic person.¹⁹⁸ Limited liability of shareholders is, however, not necessarily a logical consequence of separate juristic personality. Although a partnership is not a separate juristic person, the partners do enjoy limited liability to an extent during its existence in respect of partnership debts. Any claim which a creditor has, has to be instituted against the partners jointly and not against an individual partner. Any claim has to be first satisfied from the partnership estate and only if this is insufficient can the balance be recovered from the estates of the individual partners.¹⁹⁹ Only upon dissolution of the partnership do the partners become jointly and severally liable for the debts of the partnership.²⁰⁰

Limited liability was also not specifically mentioned as an automatic consequence of incorporation in previous companies law legislation. The 1926 Companies Act merely provided that upon registration of the memorandum of association and articles the members of the company form a body corporate with perpetual succession, which can exercise all the functions of an incorporated company.²⁰¹ Nathan²⁰² writes that this meant that the company became an entity distinct from its members and that the members enjoyed limited liability by referring, among others, to the *Salomon*²⁰³ case. Limited liability, in terms of the 1926 Companies Act, however, has to be understood within the context of the 1926 Act. The basic form of company in the 1926 Act was the unlimited

¹⁹⁸ See Blackman, Jooste & Everingham *Commentary on the Companies Act 1* (2002) 4-116; De Wet & Van Wyk *De Wet en Yeats Die Suid-Afrikaanse Kontraktereg en Handelsreg* 4ed (1978) 528-530; Cilliers & Benade *Korporatiewe Reg* 3ed (2001) 10.

¹⁹⁹ Rule 14(5)(h) of the Uniform Court rules.

²⁰⁰ *Lee v Maraisdrif (Edms) Bpk* 1976 2 SA 536 (A).

²⁰¹ Section 18(2) of the Companies Act 1926.

²⁰² Nathan *Company Law of South Africa* 3ed (1939) 87.

²⁰³ [1897] A.C. 22 [H.L].

company.²⁰⁴ Nathan's referral to the *Salomon* case is therefore only in respect of a limited company.

Although unlimited companies ceased to be the basic form,²⁰⁵ the 1973 Companies Act²⁰⁶ ("the 1973 Act") contains virtually similar wording to the 1926 Companies Act.²⁰⁷ The new Companies Act differs from its predecessors. It specifically provides that the shareholders, incorporators and directors generally are not liable for the company's debts,²⁰⁸ as a consequence of its incorporation with a separate juristic personality.

From an economic perspective it would also appear that most of the reasons which are advanced in respect of the benefits or justification of limited liability are in respect of the shareholders of the company being natural persons and not other companies. The monitoring costs of shareholders, who are natural persons, simply cannot be compared to the monitoring costs for a juristic person, especially one that controls another company. The juristic person furthermore can effectively appoint the managers of the subsidiary which further reduces any monitoring costs for the holding company. The same may be so in the case of an individual who dominates a company, but generally speaking monitoring costs do not play as an important role where groups of companies are involved compared to a company directly controlled by natural persons.²⁰⁹

In conclusion it would therefore appear that historically the principle of limited liability was not related to the existence of company groups. The fact that companies in the United States and England were prohibited from holding shares in other companies until later in the nineteenth century precludes an interpretation that one should look at the principle behind limited liability, namely shareholder protection for the existence of limited liability where groups of companies are involved. If the purpose of the principle

²⁰⁴ S 5 read with s 18(1).

²⁰⁵ Under the 1973 Companies Act, new unlimited companies could not be formed, and s 25 provided for the conversion of existing unlimited companies.

²⁰⁶ 61 of 1973.

²⁰⁷ Section 65(1).

²⁰⁸ Section 19(2).

²⁰⁹ See also Blumberg "Limited liability and corporate groups" (1985-1986) *Journal of Corporate Law* 11 573 623-626.

of limited liability was to protect a shareholder, why would there be a distinction in respect of the nature of the shareholder? No logical reason exists for the prohibition on the holding of shares by one company in another. The principle of limited liability can therefore not be accepted to apply to companies holding shares in another as it does in respect of natural person shareholders without more. Had there been no distinction between the two forms of a shareholder in a company, there would not have been a prohibition or restriction on companies holding shares in other companies when companies and therefore by implication, limited liability, were introduced by the English and United States' legislatures.

From an economic perspective it would also appear that limited liability is efficient in the context of a natural person as shareholder of the company. Although the same reasons could be advanced in the case of companies as shareholders this construction would appear to be a more forced one and make less sense than limited liability where a natural person is the shareholder.

It would appear that limited liability was a convenient, available principle with the advent of company groups. The law could merely take an existing principle and utilise it in a situation which at first blush seems much the same as the position of a natural person as shareholder but there are also important differences between the two situations.

2.7 Exception to the principle of limited liability: The doctrine of the piercing of the corporate veil in the South African law in a non-group situation

2.7.1 Introduction

It is trite law that a company is a legal person distinct from the members who compose it.²¹⁰ It is equally trite that the courts would be justified in certain circumstances to disregard the separate personality of the company, also known as the piercing of the corporate veil, to establish liability elsewhere for what are ostensibly acts of the

²¹⁰ *Dadoo Ltd and Others v Krugersdorp Municipal Council* 1920 A 530 550.

company.²¹¹ It is therefore necessary to investigate under what circumstances the courts have been willing to disregard the separate personality of a company and whether there is a difference in their approach when disregarding the separate personality was sought in cases where the individuals behind the companies were targeted for liability instead of in group situations where the possible liability of the juristic person shareholder had to be considered. Interestingly enough the principle of piercing of the corporate veil has not attracted much academic debate. Some of the academic points of view will however be discussed below.

2.7.2 Development of the doctrine of piercing of the corporate veil

*Dadoo Ltd and Others v Krugersdorp Municipal Council*²¹² was one of the first South African cases where the separate personality of a company was at stake. Although the case does not deal with the potential liability of the members of the company, the central question was whether the identity or race of the members of the company could be attributed to the company.

In the *Dadoo* case Dadoo Ltd was the owner of certain property in Krugersdorp. In terms of legislation,²¹³ Asians in the Transvaal were prohibited from being the owners of land. In terms of other legislation²¹⁴ coloured persons were also prohibited from acquiring gold rights or stands on a proclaimed gold field. The question therefore before the court *a quo* as well as the Appellate Division was whether the formation of a company by Indians was *in fraudem legis* since they, as Indians, would defeat the intention of the legislature by doing something through the instrumentality of a company that they could not achieve as natural persons. The municipality sought an order setting aside the transfer of the property to the company based on the argument that the transfer of the property to the company was *in fraudem legis* and contrary to the law. The court *a quo* held that the actions of the shareholders of Dadoo Ltd were *in fraudem legis* and the company then appealed against this decision.

²¹¹ *Cape Pacific Ltd v Lubner Controlling Investments (Pty) Ltd and Others* 1995 4 SA 790 (A).

²¹² 1920 A 530.

²¹³ Law 3 of 1885.

²¹⁴ Section 130 of the Gold Law.

The point of departure for Innes CJ was the words of Lord Macnaghten in *Salomon v Salomon & Co*²¹⁵ namely:

"[T]he company is at law a different person altogether from the subscribers to its memorandum; and though it may be that, after incorporation, the business is precisely the same as it was before, and the same persons are managers, and the same hands receive the profits, the company is not in law the agent of the subscribers or a trustee for them."²¹⁶

Innes CJ held that the shareholders *in casu* did not take advantage of a technicality, namely the incorporation of a company, but did something different in law and in substance from what was prohibited by statute.²¹⁷ Unlike the court *a quo*, which held that the incorporation of the company was *in fraudem legis* due to the fact that this would circumvent the express prohibition in the legislation, Innes CJ held that the relevant legislation did not prohibit a company, whose shareholders were of Indian origin, to acquire immovable property. This according to Innes CJ was not a technical argument but one of substance due to the fact that a company is a separate entity from its members. Ultimately the Appellate Division held that the transaction (the purchase of the property by the company from whites) was not *in fraudem legis* and refused to ignore the separate existence of the company from its members.

According to Blackman the field of piercing of the corporate veil is "an area of the law that has resisted clarity and coherence."²¹⁸ Blackman, with reference to a number of court cases, argues that a court will only pierce the corporate veil if the members of a company in effect dominate the finances, the direction of the company and the business practices of the company that lead to the transaction which is attacked, because the corporate body at no stage over the course of the transaction had a separate mind, will or existence.²¹⁹ Dominance, by itself is, however, not conclusive for the courts to ignore the separate personality of the company.²²⁰ Benade²²¹ uses the analogy of an engagement ring to

²¹⁵ Discussed in para 2.4 above.

²¹⁶ 1897 AC 22 [HL] 51.

²¹⁷ 552.

²¹⁸ Blackman et al *Commentary* 1 4-133.

²¹⁹ Blackman et al *Commentary* 4-134.

²²⁰ Blackman et al *Commentary* 4-134.

illustrate the circumstances when the separate juristic personality of a company will be ignored. The opinion or view of an engaged lady of her engagement ring differs from the view of the jeweller who made the ring. The latter looks at the components of the ring to determine its value whereas the engaged lady looks at the ring as a whole.²²² When one therefore looks at a company it is a question of perspective. One can look at the company as a whole or at its various components.²²³

There are not many reported cases in South Africa where the corporate veil has been successfully pierced, probably due to the strict rules which the courts have set before they will ignore the separate juristic personality of a company. In *Lategan and Another NNO v Boyes and Another*²²⁴ the court refers to *Orkin Bros Ltd v Bell*,²²⁵ where the directors of a company were held personally liable to a seller who sold goods to a company at the instance of its directors when they knew the company to be in insolvent circumstances and totally unable to pay for the purchase and it appeared that the sole purpose of the transaction was to diminish the personal liability of the directors under a contract of suretyship. This was held to constitute a fraud on the seller and he obtained judgment against the directors personally.

In the *Boyes* case the court then held *obiter* that:

“I have no doubt that our Courts would brush aside the veil of corporate identity time and again where fraudulent use is made of the fiction of legal personality. In the present case, however, there is no evidence that the second defendant fraudulently failed to mention the position of the sureties. In fact, the evidence shows that all parties concerned, including the attorneys acting for the mortgagor and mortgagee, forgot about the contract of suretyship when the amending agreement was signed. It follows that no question of fraud arises in this case.”²²⁶

²²¹ Cilliers, Benade, Henning, Du Plessis & Delpont *Korporatiewe Reg* 2ed (1992).

²²² Cilliers & Benade et al *Korporatiewe Reg* 9.

²²³ Cilliers & Benade et al *Korporatiewe Reg* 9. See for a more comprehensive discussion Benade “Verontagsaming van die selfstandigheid van die maatskappyregspersoon” 1967 *THRHR* 213.

²²⁴ *Lategan and Another NNO v Boyes and Another* 1980 4 SA 191 (T).

²²⁵ *Orkin Bros Ltd v Bell* 1921 TPD 92.

²²⁶ 201-202A.

In *Botha v Van Niekerk en 'n Ander*²²⁷ the court held that fraud would not be the only instance where the corporate veil would be pierced, but the court should also ask itself whether an unconscionable injustice would result should the separate personality of the company not be ignored.²²⁸

Domanski²²⁹ argued for a more balanced approach to the question whether the separate juristic personality should be ignored following the *Botha v Van Niekerk* case. He argued that the law in respect of piercing of the corporate veil, as it then was, focused on categories when piercing would be allowed. The problem of categories was that they did not always cover circumstances which justified the piercing of the corporate veil on the basis of public policy or fairness.²³⁰ Domanski, with reference to the Louisiana Supreme Court decision of *Glazer v Commission on Ethics for Public Employees*,²³¹ pleads for an approach in respect of piercing where the policy grounds justifying the separate identity of the company are balanced against the policy grounds which justify piercing of the corporate veil.²³² The traditional categories justifying piercing, for example fraud, fulfil an evidentiary role to provide an objective balance to the more subjective flexible balancing approach.²³³ Domanski, however, also argues for caution and that the separate juristic personality of the company is still the “cornerstone of our company law”.²³⁴

Larkin²³⁵ argued that there is no such doctrine as the piercing of the corporate veil.²³⁶ This argument must be viewed in the context of the time when Larkin formulated his views, in the 1980s, when the Supreme Court of Appeal had not yet authoritatively dealt with the question of piercing of the corporate veil. In brief he argues that the entity of the company, and therefore limited liability, is the essence of the company. Any liability imposed on the shareholders of the company or on the creditors of the company must be

²²⁷ *Botha v Van Niekerk en 'n Ander* 1983 3 SA 513 (W).

²²⁸ 525F.

²²⁹ Domanski A “Piercing the Corporate Veil – A New Direction” 1986 *SALJ* 224.

²³⁰ Domanski *Piercing the Corporate Veil* 225.

²³¹ 431 So 2d 752 (Louisiana 1983).

²³² Domanski *Piercing the Corporate Veil* 231.

²³³ Domanski *Piercing the Corporate Veil* 234.

²³⁴ Domanski *Piercing the Corporate Veil* 235.

²³⁵ Larkin “Regarding judicial disregarding of the company’s separate identity” 1989 *SA Merc LJ* 277.

²³⁶ Larkin *Regarding judicial disregarding* 297.

based on traditional legal principles. The piercing of the veil doctrine is for Larkin “an extremely useful name [for the basis to hold the shareholders or directors of a company personally liable] while we learn to understand what it is.”²³⁷

The Appellate Division had the opportunity to consider the question of the piercing of the corporate veil in *Cape Pacific Ltd v Lubner Controlling Investments (Pty) Ltd*.²³⁸ In this case the appellant purchased certain shares in a third company from the first respondent in 1979. The first respondent refused to transfer the shares and the appellant obtained judgment against the first respondent for the transfer of the shares in 1987. The shares were, however, sold in the second half of 1979 to the second respondent. The second respondent was never joined in the original action for the transfer of the shares in 1987. One Lubner was in total control of the first and second respondents. According to the court, on the assumption that the second respondent took transfer of the shares from the first respondent with full knowledge of the appellant’s rights to the shares, it was open to the appellant, when it came to its notice that the shares had been transferred to the second respondent, to join the second respondent in the original action and claim transfer of the shares based on the doctrine of notice. The appellant did not make use of this opportunity and his claim against the second respondent had prescribed.

The sole cause of action on which the appellant eventually relied was that Lubner, with the knowledge of the rights of the appellants, and in fraud of such rights, caused the relevant shares to be transferred from the first respondent to the second respondent. The court was therefore entitled, so the argument went, to disregard the separate corporate personalities of the first and second respondents to give effect to the judgment in the original action for delivery of the relevant shares to the appellant.

The court *a quo* found that Lubner had full control over the first and second respondents and that the relevant shares had been transferred from the first respondent to the second respondent on the instructions of Lubner in an attempt to thwart the appellant’s claim to

²³⁷ Larkin *Regarding judicial disregarding* 298.

²³⁸ *Cape Pacific Ltd v Lubner Controlling Investments (Pty) Ltd and Others* 1995 4 SA 790 (A).

the shares. Notwithstanding this factual finding the court *a quo* refused to disregard the separate corporate personalities of the first and second respondents. It held that although the transfer of the shares between the first and second respondent was “clearly improper”; that their transfer did not constitute an “unconscionable injustice;” that the appellant had the opportunity to recover the shares from the second respondent but did not do so timeously and was therefore at fault for its loss.²³⁹

The Appellate Division accepted the factual findings of the court *a quo*. It had to decide, based on the proven facts, whether the separate corporate personality of the first and second respondents should be ignored in respect of the transfer of the relevant shares.

The Appellate Division analysed the history of the principle of the separate juristic personality of a company and started off with the House of Lords decision of *A Salomon v A Salomon and Co Ltd*.²⁴⁰ It was already tentatively accepted in that case that fraud or dishonesty may be grounds upon which a court will ignore the principle of separate juristic personality. The court continued with the historic analysis and came to the conclusion that it had become settled law that fraud and improper conduct could provide grounds for disregarding the separate corporate personality of a company. The Court referred to *The Shipping Corporation of India Ltd v Evdomon Corporation*²⁴¹ where Corbett CJ said the following:

“It seems to me that, generally, it is of cardinal importance to keep distinct the property rights of a company and those of its shareholders, even where the latter is a single entity, and that the only permissible deviation from this rule known to our law occurs in those (in practice) rare cases where the circumstances justify "piercing" or "lifting" the corporate veil. And in this regard it should not make any difference whether the shares be held by a holding company or by a Government. I do not find it necessary to consider, or attempt to define, the circumstances under which the Court will pierce the corporate veil. Suffice it to say that they would generally have to include an element of fraud or other improper conduct in the establishment or use of the company or the conduct of its affairs. In this connection the words "device", "stratagem", "cloak" and "sham" have been used.”²⁴²

²³⁹ *Cape Pacific Ltd v Lubner Controlling Investments (Pty) Ltd and Others* 1993 2 SA 748 (C) 822B-C.

²⁴⁰ 1897 AC 22 [H.L.] 51.

²⁴¹ *The Shipping Corporation of India Ltd v Evdomon Corporation and Another* 1994 1 SA 550 (A).

²⁴² 566C-F.

Smalberger JA raised two points in the *Cape Pacific* case, which according to him arose from the *Evdomon* case. First of all the importance of the separate corporate personality of a company should not be lightly disregarded but on the other hand where fraud, dishonesty or other improper conduct is present other considerations come into play. The need to maintain the separate personality of a company should then be balanced against policy considerations which may arise in favour of disregarding the corporate veil although this “balancing test” approach was not part of the *Evdomon* case.²⁴³

Secondly a company does not have to be incorporated for fraudulent purposes before a court may disregard its separate juristic personality. What is of importance is whether the separate personality of the company was abused in a specific situation to perpetrate fraud or for a dishonest or improper purpose.²⁴⁴

With reference to the decision of Flemming J in the *Botha v Van Niekerk*²⁴⁵ case, where Flemming J held that there should be an unconscionable injustice before a court will pierce the corporate veil, Smalberger JA held that a court should avoid too rigid a test but should opt for a more flexible approach, namely a test which allows the facts of each case to determine whether the disregarding of the corporate veil is justified. Furthermore, there is no authority for the proposition that piercing of the corporate veil is a remedy of last resort and only available where there is no other remedy.²⁴⁶

Smalberger JA eventually held that the corporate veil may be pierced in this instance without making it clear on what basis. He found that there was seriously improper conduct. It is not clear whether his decision was based upon the first group of fraud, dishonesty or improper conduct, or on the second basis which he mentions, namely policy considerations or thirdly a decision based on the facts of the case or on a balance

²⁴³ 803F.

²⁴⁴ 804B.

²⁴⁵ 1983 3 SA 513 (W).

²⁴⁶ 805D. Compare *Hülse-Reutter and Others v Gödde* 2001 4 SA 1336 (SCA) 1347B where Scott JA held that due to the “very exceptional nature of the relief [...] requires, in the circumstances of the present case, that he [the respondent] should have no other remedy.”

of the various tests. It would appear that piercing of the veil was allowed in terms of policy considerations, although Smalberger JA does state that the transfer of the relevant shares was to defraud the rights of the appellant.²⁴⁷ Cilliers and Luiz²⁴⁸ argue that the *Cape Pacific* case was decided on policy considerations.²⁴⁹ The authors confirm that a court does not have a general discretion to ignore the separate identity of the company when it appears just to do so. They do, however, acknowledge that a strict application of the law in cases, where “exceptional factual circumstances are present, could result in an injustice,”²⁵⁰ like in the *Cape Pacific* case. They therefore agree with the judgment of Smalberger JA in the *Cape Pacific* case that a more flexible approach should be adopted when a court is confronted with the question of whether to pierce the corporate veil and that each case should be approached from a casuistic point of view.²⁵¹

In the subsequent case of *Hülse-Reutter and Others v Gödde*²⁵² Scott JA said the following:

“The circumstances in which a court will disregard the distinction between a corporate entity and those who control it are far from settled. Much will depend on a close analysis of the facts of each case, considerations of policy and judicial judgment. Nonetheless what is, I think, clear is that as a matter of principle in a case such as the present there must at least be some misuse or abuse of the distinction between the corporate entity and those who control it which results in an unfair advantage being afforded to the latter.”²⁵³

It is unclear from this statement of the Supreme Court of Appeal as to which test would apply when a court is requested to disregard the separate personality of a company. What is, however, clear from the decided cases is that some form of impropriety needs to be present before a court would disregard the separate personality of a corporate entity. When an attempt is made to use these rather vague tests in a group situation, it would be futile where the group forms a single economic unit but there is no question of fraud, dishonesty or improper conduct. What would be left would be the question of policy

²⁴⁷ 804F.

²⁴⁸ Cilliers & Luiz “The Corporate Veil – An Unnecessarily Confining Corset?” 1996 *THRHR* 53

²⁴⁹ Cilliers & Luiz *The Corporate Veil* 525.

²⁵⁰ Cilliers & Luiz *The Corporate Veil* 527.

²⁵¹ Cilliers & Luiz *The Corporate Veil* 527.

²⁵² *Hülse-Reutter and Others v Gödde* 2001 4 SA 1336 (SCA).

²⁵³ 1346A-C.

considerations and judicial judgment. But as can be seen from the last sentence from the abovementioned extract from the *Hülse-Reutter* case, some form of abuse which results in an unfair advantage would need to be present to justify piercing of the corporate veil.

The question therefore has to be raised whether the test for piercing the corporate veil as formulated and applied by the South African courts is sufficient to address adequately the problems which arise within the context of groups as mentioned above.²⁵⁴ This question will be discussed below in relation to delictual liability in the context of company groups.²⁵⁵ It is submitted that the balancing test which Domanski pleads for and which argument the court in *Cape Pacific* refers to,²⁵⁶ could be the test which the courts should adopt. The Appellate Division in *Cape Pacific* did not reject the argument of Domanski and it even appears that the balancing test could also have been the basis for the judgment.²⁵⁷

²⁵⁴ Para 1.4 above.

²⁵⁵ Chapter 6 below.

²⁵⁶ 803.

²⁵⁷ At 806 the Court of Appeal balances the conduct of Cape Pacific (not utilizing an alternative remedy which then prescribed) against the conduct of Lubner. In essence the court weighed up the factors justifying piercing the corporate veil and the factors justifying maintaining the separate identity of the companies in question.

Chapter 3

A group of companies from an economic perspective

3.1 Introduction

Chapter one gave an overview of what company groups are and, briefly, the reasons for their existence and the problems they pose. The second chapter provided an overview of the principle of limited liability and showed that the economic arguments to support limited liability are not necessarily applicable to company groups. Chapter two also showed that the historical origins of company groups do not correspond with the advent of limited liability and that limited liability in the context of company groups is not necessarily justified. The aim of this chapter is to give an economic analysis of a group of companies. The purpose of this analysis is to determine whether a group of companies can be seen as a firm / single economic entity from an economic perspective.

The discussion commences by looking at the relationship between the law and the field of economics. Then the concept of a firm will be investigated, including how a firm can be organised most effectively. Thereafter the group will be looked at and how it fits in with the concept of a firm. The chapter concludes by showing that from an economic point of view a group of companies can exist as a single entity. This is an important conclusion for this dissertation because, if a group of companies forms an economic unit, it must then be asked whether the law should not give more recognition to this. However, it has to be borne in mind that not all groups of companies would constitute single economic units or firms. A distinction will have to be drawn between holding companies having subsidiaries as investments, for example a holding company which wants to diversify and invest in a number of businesses unrelated to its core business and a holding company, which conducts a single business using subsidiaries. For example, there are multinational companies, with the parent company situated in one country and having subsidiaries all over the world, which conduct the same business as the parent company. Only in the latter situation could the argument of a single economic unit or firm be properly entertained. Therefore, what follows below is an investigation of a group of companies in

the context of a group consisting of separate legal entities but which are dependent on the holding company with respect to management, funding and policy.

The simplest example of a group of companies, a group consisting of two companies, comes into existence in two possible ways. In the first place it can come into existence by means of the creation of a new company with the sole shareholder or majority shareholder being the holding company and the newly created company being the subsidiary. In the second place a company may buy the majority shareholding, or all the shares, in another company and thus effect a takeover of the last-mentioned company. The company being taken over now becomes the subsidiary of the purchasing company.

Why would one company want to effect either a takeover or create a new company? From an economic perspective it could be to minimise transaction costs and to achieve maximum profits for the group, or at least for the holding company.¹ There is also the legal benefit attached to such a course of action by the holding company. The benefit of separate juristic personality ensures that the subsidiary is a distinct juristic person from the holding company. The holding company, in general, is not responsible for the debts of the subsidiary.² This benefit allows the holding company, by means of its control of the subsidiary company, to engage in courses of business which are of a high risk nature. Should the venture fail the holding company only suffers the loss of its shareholding which would be negligible especially where it created the subsidiary with a token amount of share capital.

Murphy advances several reasons or benefits from an economic or business perspective relating to the creation of a group of companies.³ According to Murphy these reasons or benefits would include the following:

“(a) separate companies may enhance decentralization of decision-making in large corporate groups;

¹ See para 3.6 below.

² See chapter 2, para 2.1 above in respect of the principle of limited liability.

³ Murphy “Holding Company Liability for Debts of its Subsidiaries: Corporate Governance Implications” 1998 10 *Bond Law Review* 241-272 http://www.bond.edu.au/study-areas/law/publications/BLR/vol 10-2/Murphy 10_2 pdf [accessed 19 June 2007].

- (b) flexibility so as to isolate to separate entities and not across the entire group regulatory controls and regimes that would apply if only one corporate entity was used;
- (c) particular foreign jurisdictions may insist upon a locally incorporated subsidiary;
- (d) the ability to sell the entire company or business through the sale of shares, whether for tax or operational reasons;
- (e) maintaining the ‘goodwill’, loyalty of employees, or ‘brand’ name after a takeover which would otherwise be threatened through a complete integration;
- (f) a separate company may well provide legislative force to maintain a convenient unit for management and accounting; and
- (g) the costs in formally and finally transferring assets, services, employees, contracts with third parties and liabilities may be prohibitive because of the size of administrative costs, financial imposts (eg stamp duties) or tax consequences.”⁴

It would appear from the above that efficiency, effective control and costs are important factors for a company to create or acquire subsidiary companies. Coupled with these factors is the legal benefit of limited liability which would reduce the risk for the parent company should the subsidiary fail. If the subsidiary company fails the only loss for the parent company will be its investment, which in many cases, will not be substantial.

3.2. Law and Economics

The first question that needs to be asked and answered is whether there is a place for an economic approach to law. This is a contentious issue.⁵ In *Bank of Tokyo Ltd v Karoon*⁶ Goff LJ held, in the context of a holding company and subsidiary company forming a single economic unit, that “we are concerned not with economics but with the law. The distinction between the two is, in law, fundamental and cannot *here* be bridged.”⁷ In *Adams v Cape Industries plc*⁸ the English Court of Appeal approvingly referred to the statement of Goff LJ.⁹ It is interesting to note that Goff LJ used the word “here.” This could be interpreted that it was only in the specific case that the distinction between the

⁴ Murphy *Corporate Governance Implications* 250.

⁵ Burrows & Veljanovski *The Economic Approach to Law* (1993) 1.

⁶ [1987] AC 45

⁷ 64 [my italics].

⁸ *Adams v Cape Industries plc* [1990] Ch 433.

⁹ 538.

two fields could not be bridged and that he did not mean to make a general statement that it would never be possible to bridge the divide.

The economic approach to law was traditionally confined to subjects with an economic basis, for example competition law but more recently the field of economics has also shifted to “non-market” legal subjects like the law of marriage.¹⁰ Central to the economic approach is the idea that any person is confronted with a choice. The choice that is made is then based on a number of premises which usually should lead to a rational choice, although there is consensus among economists that not all persons are rational and therefore by implication that not all choices will be based on rationality.¹¹ In the market arena, therefore, any decision should normally be rational and usually the common denominator in formulating a choice would be the cost factor of the choice that is exercised.¹² It is also stated that the study of law is attractive to scholars of economics because law provides them with a “wealth of material for evaluating theories of rational behaviour.”¹³

An economic analysis of law takes two approaches, namely a positive approach and a normative one. According to Miceli¹⁴ the positive approach to law tends to reflect economic reasoning, namely efficiency is seen as a social goal that is reflected in the law. The normative approach investigates how the law can be improved to become more efficient.¹⁵ Using the latter approach it must first be determined how to run a business efficiently and whether the law impedes this potential efficiency. The best way to achieve efficiency could be to conduct business through a firm, but this begs the question of how the law views a firm. It is thus necessary to investigate what a firm is.

¹⁰ Burrows & Veljanovski *Economic Approach* 2-3.

¹¹ Burrows & Veljanovski *Economic Approach* 3-4.

¹² Burrows & Veljanovski *Economic Approach* 4.

¹³ Miceli *The Economic Approach to Law* (2004) 1.

¹⁴ Miceli *Economic Approach to Law* 2.

¹⁵ Miceli *Economic Approach to Law* 2.

3.3. The Firm

The firm can take on various forms including a company. According to Hart¹⁶ the firm has traditionally been treated as a “black box”. It has just been accepted as something that is there and the reasons for its existence and the manner in which it was conceived was not thought through. Bratton refers to the firm as “bundles of unruly phenomena”.¹⁷ He refers to the firm in this manner in the light of the fact that firms are not only centres of production but also because natural persons are responsible for the production. Bratton also states that there is no fixed theory of what a firm is but that it is an evolving concept which differs from person to person.¹⁸

Robertson has described firms as “islands of conscious power in an ocean of unconscious co-operation like lumps of butter coagulating in a pail of buttermilk.”¹⁹ Ricketts refers to the firm as “simply the fundamental microeconomic unit in the theory of supply”.²⁰ According to Ricketts the firm can be seen as a consequence of two continuous problems in economic activity. First of all the operative environment of economic activity finds itself in a perpetual sea of change and coupled to that problem is the concomitant need of flexibility to adapt to the changing environment or conditions. The firm is therefore the ideal vehicle to cope with change.

The second problem that Ricketts identifies is that agreements that are entered into by contracting parties need to be enforced. This could then either lead to a longstanding close working relationship based on trust and the generation of goodwill or it may lead to a system where parties to an agreement implement monitoring systems with the back-up of sanctions should there be non-compliance with agreements. The firm again becomes the ideal tool to enforce agreements.²¹ He further argues that firms are established to

¹⁶ Hart “Incomplete Contracts and the Theory of the Firm” in Williamson & Winter *The Nature of the Firm Origins, Evolution and Development* (1993) 138.

¹⁷ Bratton “The ‘nexus of contracts’ corporation: A critical appraisal” 1989 74 *Cornell Law Review* 407.

¹⁸ Bratton *Nexus* 407.

¹⁹ Robertson & Dennison *The Control of Industry, Cambridge Economic Handbook* (1960) 73.

²⁰ Ricketts *The Economics of Business Enterprise* (2002) 3.

²¹ Ricketts *Business Enterprise* 25.

counter the threat of transaction costs. An entrepreneur will establish a firm in the belief that he will reduce the costs associated with “achieving coordinated effort”.²²

Another way of looking at the firm is to see it as a number of agreements which are bound together in such a manner as to provide flexibility in an unstable environment within which a business operates.²³ The instability of the business environment leads to uncertainty and, according to Ricketts, the consequential difficulty of providing a clear picture of the provisions of a contract with a person constituted the “starting point for the theory of a firm”.²⁴

The first person to look at the firm and the rationale behind it was Coase who wrote his seminal work on the firm in 1937.²⁵ Coase referred to Robinson²⁶ when he set out to determine the nature the firm. Robinson held that two questions need to be asked when certain assumptions are made in economics; firstly whether these assumptions are “tractable” and secondly whether they fit in with reality.²⁷ Coase therefore set out not only to define the firm but also to define it in a manner that is not oblivious to reality and that is also tractable. “Tractable” in this context is with reference to tools used in economic analysis, namely “the idea of margin and that of substitution”.²⁸

To understand the firm better one must first understand the economic system within which a firm functions. According to Coase,²⁹ with reference to Hayek,³⁰ an economist views an economic system as being coordinated by the price mechanism and that society is not therefore an organisation but an organism. The economic system therefore “works

²² Ricketts *Business Enterprise* 17.

²³ Ricketts *Business Enterprise* 43.

²⁴ Ricketts *Business Enterprise* 43.

²⁵ Coase “The nature of the Firm” 1937 4 *Economica* n.s reproduced in Coase *The Firm, the Market and the Law* (1988).

²⁶ Robinson *Economics is a Serious Subject* (1932) 12.

²⁷ Coase *The Firm, the Market and the Law* 33.

²⁸ Coase *The Firm, the Market and the Law* 34.

²⁹ Coase *The Firm, the Market and the Law* 19.

³⁰ Hayek “The Trend of Economic Thinking” 13 *Economica* (1933) 121-137.

itself". The utilisation of resources is therefore directed by price. According to Coase³¹ production will be determined by the market in the form of price movements.

The market consists of a number of exchange transactions. Within a firm these transactions are eliminated and production is determined by an entrepreneur. Although production is possible outside a firm, the firm is necessary because it would greatly reduce transaction costs which would be incurred in the market.³² The resources of a firm could be better managed within a firm than outside the firm.

Coase, however, also realised that not all market transactions could be done within one firm since at some point the internal organisation within a firm would become more expensive than the transaction costs on the open market.³³ The size of a firm becomes important. Should it be too large the whole idea underlying a firm would be lost, namely the intention to save on transaction costs which would have been incurred in the market place. Coase argues that a firm will be bigger:

- a) "the less the costs of organizing and the slower these costs rise with the an increase in the transactions organized;
- b) the less likely the entrepreneur is to make mistakes and the smaller the increase in mistakes with an increase in the transactions organized;
- c) the greater the lowering (or less the rise) in the supply price of factors of production to firms of a large size."³⁴

There have been three major economic theories of what a firm is. These theories are the managerial theory, the neoclassical economic theory and the institutional theory.³⁵ The last two mentioned theories are in essence variants of the same theory, namely the new economic theory of the firm.³⁶

³¹ Coase *The Firm, the Market and the Law* 19.

³² Coase *The Firm, the Market and the Law* 21.

³³ Coase *The Firm, the Market and the Law* 24.

³⁴ Coase *The Firm, the Market and the Law* 24.

³⁵ Bratton "The New Economic Theory of the Firm: Critical perspectives from History" 41 *Stanford Law Review* (July 1989) 1471.

³⁶ Bratton *Nexus* 411.

The managerial theory focuses on the governance aspect of the firm, especially the fact that management has hierarchical power. This power exists due to the expertise which managers have in co-ordinating resources for production.³⁷ Bratton identifies three aspects of this hierarchical power of management. Firstly it will be management which decides on the produce and volumes to be produced as well as the distribution thereof. Secondly management exercises authority over the employees of the particular enterprise and thirdly management-dominated firms imposed externalities.³⁸ This means that management has shifted the costs of their relationship with shareholders to outside parties. Criticism of this theory of the firm focused on the issue that managers did not wield their power legitimately. Critics identified three aspects in this respect. First of all, management exercised its powers in terms of a statutory vested power subject to the approval of the shareholders of the company. Secondly management controlled the board of directors, and thirdly the financial environment and community supported management.³⁹

The new economic theory has two variants as mentioned above. Coase was the influential voice in respect of the institutionalistic point of view. As shown above, Coase identified the market and the firm as the two ways in which contracts would be entered into and that the issue of transaction costs determined which one of the two would be chosen.⁴⁰ The firm, in effect, is a nexus of contracts.⁴¹ The neoclassical theory is not fundamentally different to the institutionalist perspective and also focuses on the firm as a nexus of contracts.

From the above it would appear that the firm is an entity for the organisation of production, or, an institution to allocate the resources for production to avoid, or at least decrease, the transaction costs which would have been incurred had contracts been entered into in the market place with outsiders like suppliers and marketers.

³⁷ Bratton *Critical Perspectives* 1476.

³⁸ Bratton *Critical Perspectives* 1476.

³⁹ Bratton *Critical Perspectives* 1476.

⁴⁰ Bratton *Critical Perspectives* 1478.

⁴¹ Bratton *Critical Perspectives* 1480.

The above does not, however, bring us any closer to understanding how a group of companies fits into the concept of a firm. As a next step the internal organisation of a firm needs to be investigated.

3.4 The firm, hierarchies and internal integration

The purpose here will be to ascertain what determines the organisational structure of a firm. A firm can be organised in a diverse number of forms, namely by means of vertical, horizontal and geographical integration.⁴²

Vertical integration means that a firm which produces a certain product will integrate the whole production process of that product within the firm. The firm will therefore, for example, invest in the raw materials required for its product and not only specialise in the production of the product. The acquisition of the raw materials is therefore internalised within the firm.⁴³ From the raw material stage all the subsequent stages of the production chain, ending in the product, are also internalised. The marketing of the product, conceivably, may also be undertaken by the same firm. The production of the end product is therefore not necessarily the end of the vertical integration process.

As reflected by the *Walkovsky v Carlton*⁴⁴ case, horizontal integration is also possible, where one person or company controls a number of companies which conduct the same business, for example in the hotel industry or taxi industry. Each hotel or taxi is operated through a separate company. According to Ricketts, firms conduct business either in a specialised sphere or diversify into a number of different products.⁴⁵ Where a firm diversifies its business into a number of unrelated fields, it is known as conglomerate diversification.⁴⁶

⁴² Ricketts *Business Enterprise* 217.

⁴³ See for further examples and in more detail Ricketts *Business Enterprise* 218.

⁴⁴ *Walkovsky v Carlton* 18 N.Y. 2d 414, 223 N.E. 2d 6, 276 N.Y.S. 2d 585.

⁴⁵ Ricketts *Business Enterprise* 219 refers to Pilkington Brothers, who, for example have always been involved with glass. He also, citing an article in *The Times* of 12 July 1985 19, based on an analysis by Hoare-Govett, refers to Guinness which in the mid 1980s expanded into another business areas in which they were not previously involved.

⁴⁶ Ricketts *Business Enterprise* 218- 219.

International integration, according to Ricketts, is the “combining in a single firm of operations in many different locations and often in different countries.”⁴⁷ He states furthermore that the standard economic theory is not fully able to explain the reasons for this type of integration. One conceivable explanation could be that it is nothing but vertical integration transcending national borders. This cannot, however, explain the structure of a number of transnational businesses.⁴⁸

It has been shown above that a firm can be integrated in a number of ways. These ways all point toward the formation of some form of group structure, whether vertical, horizontal or international. This now begs the question whether a group of companies constitutes a firm and how it is managed.

3.5 A group of companies as a firm

This section will be largely based on the views of Williams.⁴⁹ The question that Williams raises is how does the management of a company group work? Is the group managed as one entity or is it managed as a number of separate entities? Williams calls this the management dilemma.⁵⁰

As will be shown below,⁵¹ transaction costs influence whether an entrepreneur would conduct business through the conclusion of a number of contracts in the market place. This, however, increases transaction costs. When these transaction costs can be avoided, or at least minimised, the option that allows this will naturally be chosen. Thus a firm is established and within it hierarchies are established and an integration of processes follows.

⁴⁷ Ricketts *Business Enterprise* 219.

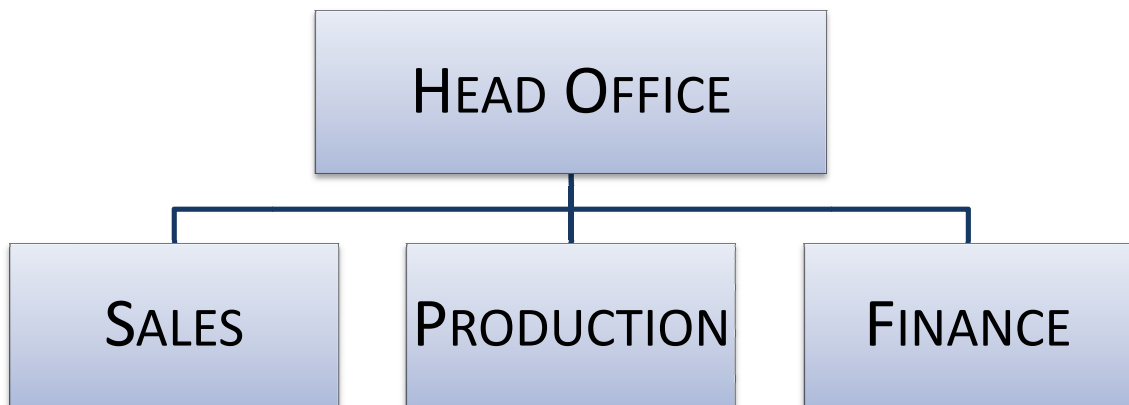
⁴⁸ Ricketts *Business Enterprise* 220.

⁴⁹ Williams “Corporate Groups: The Management Dilemma” in Gillooly *The Law relating to Corporate Groups* (1993) 30.

⁵⁰ Williams *Corporate Groups* 30.

⁵¹ Para 3.6 and see also para 3.3 above.

Firms organise themselves internally in a number of forms.⁵² Within a smaller firm the unitary form is popular. This is a vertical hierarchical form and controlled from a central power. The structure is divided into departments and each departmental manager concentrates on his area and reports to a central office. According to Ricketts this structure is only effective in enterprises which have a limited field of products.⁵³ Ricketts uses the following example to illustrate the structure of a firm organised on the basis of horizontal integration.⁵⁴



Ricketts mentions that the bigger firms became in the United States of America during the first half of the twentieth century, the more firms started to use different administrative structures to organise themselves.⁵⁵ The most popular structure to use was the multidivisional form, also known as the M-form. According to Ricketts this structure is especially apt for conglomerate and transnational expansion and “the diversified

⁵² Ricketts *Business Enterprise* 221.

⁵³ Ricketts *Business Enterprise* 221.

⁵⁴ Ricketts *Business Enterprise* 221.

⁵⁵ Ricketts *Business Enterprise* 222.

corporation could not have reached the stage that it has without this organisational innovation”.⁵⁶

A diversified corporation often comes into being by means of a takeover. One independent firm will attempt to take over another firm in the hope that it will increase its profits. According to Williams,⁵⁷ enterprises merge due to synergy. Synergy means the belief that profits will increase when two independent enterprises merge. Although Williams refers to mergers,⁵⁸ the same principle would apply to a takeover.⁵⁹

Williams refers to enterprises which in the context of groups of companies, will move power away from the centre of the enterprise through decentralisation or devolution. For example, the enterprise may have various production centres, each a separate legal entity, across a country. Alternatively the enterprise could have different subsidiaries with each subsidiary responsible for a different product of the enterprise. Williams further suggests that in both these situations, the synergies stretch across the individual legal entities. Williams further argues that the most important synergies that need to be understood within the context of an enterprise, which consists of various legal entities, can be classified under the following headings, namely economies of scope, pricing effects and internal capital markets.⁶⁰

3.5.1 Economies of scope

According to Williams this means the saving of costs when various entities integrate their business activities.⁶¹ An example would be where a car manufacturer produces more than one model and thus is able to use the same equipment on the various models.⁶²

⁵⁶ Ricketts *Business Enterprise* 222.

⁵⁷ Williams *Corporate Groups* 33.

⁵⁸ Weinberg & Blank *Take-overs and Mergers* 5ed 37 (1) (2008) 1005 define a merger as “a marriage between two companies, generally of roughly equal size.”

⁵⁹ Weinberg & Blank *Take-overs and Mergers* 1005 defines a takeover as the acquisition of control of a smaller company by another (larger) company.

⁶⁰ Williams *Corporate Groups* 34.

⁶¹ Williams *Corporate Groups* 34.

⁶² Williams *Corporate Groups* 34 refers to this example with reference to the research of Friedlander, Winston and Wang “Costs, Technology and Productivity in the US Automobile Industry” (1983) *Bell Journal of Economics* 14 1-20.

3.5.2 Pricing Effects

The synergy achieved by pricing effects is usually as a result of the utilisation of an input within a vertical chain. This means that where a group of companies exists in the form of a holding company, its subsidiary and the subsidiary of the first mentioned subsidiary, the last mentioned subsidiary would produce an input which will then be either improved or used by its holding company and then eventually by the ultimate holding company.⁶³ The net effect of this system is that the input and supply prices within the vertical chain will not adversely affect the profit within the vertical group, i.e. the profit of the group will be higher than it would have been had the entities in the vertical chain been totally independent entities.⁶⁴

3.5.3 Internal capital markets

The capital market is in theory an effective mechanism to ensure that an enterprise is run effectively and efficiently.⁶⁵ Williams⁶⁶ mentions that internal control measures within a company group may have certain benefits over external capital markets in respect of the effective management of individual enterprises. Effective control and integration of all the activities of each legal entity within the group are required to maximise the efficiency of the group of companies as a single enterprise, compared to the situation where these entities are all independent and the level of central control much less.⁶⁷

3.6. The role of transaction costs

Despite the above synopsis of synergies the reason for forming company groups has still not been explained. It is clear that an enterprise in the wide sense can integrate or coordinate its business activities in two ways. It can either do so by means of a series of

⁶³ Williams *Corporate Groups* 35.

⁶⁴ Williams *Corporate Groups* 37.

⁶⁵ Williams *Corporate Groups* 37.

⁶⁶ Williams *Corporate Groups* 37 with reference to Williamson *Markets and Hierarchies: Analysis and Antitrust Implications* (1975) Chapter 9 n 2.

⁶⁷ Williams *Corporate Groups* 38.

contracts with independent contractors in the market place⁶⁸ or through a hierarchic organisation which *de iure* consists of a number of separate legal entities but which *de facto* constitutes one single economic unit.

According to Williamson⁶⁹ transaction costs are the “costs of running the economic system”.⁷⁰ This is, however, not the same as the narrower concept of production costs which is what economic analysts have been mostly occupied with in recent times. Williamson further avers that transaction costs are the “economic equivalent of friction”⁷¹ which is encountered in the field of physics. This analogy stems from the averment that friction is ubiquitous in the physical world in which we live and should always be taken into account. Similarly in the world of economics there are certain factors which are pervasive in running the economic system.⁷² One of these factors is transaction costs, a factor which is not often found in earlier literature on the running of the economic system. According to Williamson economists admitted that there was a factor like friction in the economy but there was no terminology to describe this friction.⁷³

Williamson asserts that the failure to take transaction costs into account has certain consequences:

“The neglect of transaction costs had numerous ramifications, not the least of which was the way in which nonstandard modes of economic organization were interpreted. Until express provision for transaction costs was made, the possibility that nonstandard modes of organization – customer and territorial restrictions, tie-ins, block booking, franchising, vertical integration, and the like – operate in the service of transaction cost economizing was little appreciated. Instead, most economists invoked monopoly explanations - be it of the leverage, price discrimination, or entry barrier kinds - when confronted with nonstandard contracting practices.”⁷⁴

⁶⁸ See para 3.3 above.

⁶⁹ Williamson *The Economic Institutions of Capitalism* (1985) 18.

⁷⁰ Williamson *Economic Institutions* 18 18, with reference to Arrow “The Organization of economic Activity: Issues pertinent to the choice of markets versus nonmarket allocation” *In The Analysis and Evaluation of Public Expenditure: The PPB System*. 1 US Joint Economic Committee, 91st Congress, 1st session.

⁷¹ Williamson *Economic Institutions* 19.

⁷² Williamson *Economic Institutions* 19.

⁷³ Williamson *Economic Institutions* 19.

⁷⁴ Williamson *Economic Institutions* 19.

The firm was only seen as a production centre before transaction costs were recognised as the prevalent factor in economic organisation.⁷⁵

Transaction costs are those costs which are incurred when the terms of contracts are being negotiated as well as those costs which are incurred where breach of contracts occur and the contracts need to be enforced.⁷⁶ It would be natural that each party to the contract would seek to negotiate the most beneficial terms for itself in the contract.

Transaction costs could be *ex ante* or *ex post facto*.⁷⁷ *Ex ante* costs are the costs associated with the conclusion of a specific contract like the negotiations which need to take place as well as the actual drafting (often by attorneys), which could become complex since the parties would seek to cover all possible eventualities in a pre-emptive manner. *Ex post facto* costs are the costs associated with the enforcement of contracts where disputes have arisen.⁷⁸

Where one party is in a stronger bargaining position than the other party, especially in an ongoing relationship, he can force the weaker party to continue dealing with him despite the disadvantageous terms for the weaker party. This is called an *ex post* bilateral monopoly.⁷⁹ An example would be a car manufacturer who is dependent on a tyre manufacturer for the tyres of its vehicles. In principle the vehicle manufacturer would be dependent on the tyre manufacturer to a greater extent than *vice versa*. This is, however, conditional upon other tyre brands not being available. This *ex post* bilateral monopoly is also known as hold-up. Dependency on a party within a contractual relationship may lead to hold-up since the stronger party may literally hold the weaker one to ransom in respect of fees or prices.

⁷⁵ Williamson *Economic Institutions* 19.

⁷⁶ Williams *Corporate Groups* 39.

⁷⁷ Williamson *Economic Institutions* 19.

⁷⁸ Williamson *Economic Institutions* 19.

⁷⁹ Williams *Corporate Groups* 40 with reference to Casson "The Theory of Vertical Integration: A Survey and Synthesis" (1984) *Journal of Economic Studies* 11 3-43.

Where two parties, as in the example described above, are independent the transaction costs for the weaker party are much higher than they should be. Where the vehicle manufacturer is able to internalise the transaction costs by owning the tyre manufacturer it is able to manage its costs much more efficiently and in fact reduce its transaction costs.

Transaction costs economics also investigate how people behave when they enter into contractual agreements. Important in this respect is how industries organise themselves. According to Williamson industrial organisation examines what goals the parties to a contract are attempting to achieve. Two important components of industrial organisation come to the fore here, namely monopoly and efficiency.⁸⁰

It was mentioned above that traditionally all contracts were entered into at the market but that Coase then researched the firm and the reasons for supplanting the market as the mode of contracting.⁸¹ The question that the monopoly and efficiency approaches seek to answer is why traditional market transactions are being replaced by non-market vehicles of economic organisation.⁸² The monopoly approach argues that the departure from the traditional market-type contract is due to monopoly purposes, whereas the efficiency approach argues that there is some economic rationale behind this departure from traditional market-type contractual arrangements.⁸³

There are a number of monopoly approaches of which the important one for the purposes of this research is the one regarding vertical integration within a firm. Here the approach looks at the expansion of a firm by integrating processes by means of mergers or the creation of subsidiaries and the effect on the firm's competitors.

⁸⁰ Williamson *Economic Institutions* 23.

⁸¹ Para 3.3 above.

⁸² Williamson *Economic Institutions* 23.

⁸³ Williamson *Economic Institutions* 23.

More important, however, is the efficiency approach to economic organisation. Why do firms exist and why are market transactions replaced with non-market transactions, for example, by vertically integrating production within a firm?

The efficiency side of economics focuses on the *ex ante* side of contracting.⁸⁴ This side of economics acknowledges that the ownership of assets is important and is therefore also known as property-rights economics. Ownership of an asset leads to the rights of the owner to use the asset, to receive any income derived from a particular asset and the right to deal with the asset in any particular manner.⁸⁵ Implicit in this ownership idea is therefore the ability of the owner to exercise control over an asset, for example from a raw product up to the final product, including control over the alienation of the asset.

It was shown above that non-market transactions are viewed as non-standard forms of contracting and that the transaction costs economics argue that the reason for this non-standard contracting is to achieve efficiency.⁸⁶ The transaction costs perspective can be divided into a governance branch and a measurement branch,⁸⁷ of which the governance branch is more important for purposes of this dissertation. The reason why the focus is on governance concerns the reasons why a firm would create various subsidiaries and how that firm is governed. Control over these subsidiaries as assets becomes important and, apart from the economic reasons for creating subsidiaries, it is important to know how control is achieved and whether such control is efficient.

Economic organisation makes two behavioural assumptions. In the first place humans are subject to bounded rationality.⁸⁸ This implies that humans have a limited sphere of rational behaviour and are bound to succumb to opportunistic behaviour. The second assumption is asset specificity. This means that in standard contractual arrangements one party, for example the supplier of automobile parts to a motor vehicle manufacturer, invests in a plant that is asset specific to the manufacturer. This supplier is at a real risk

⁸⁴ Williamson *Economic Institutions* 26.

⁸⁵ Williamson *Economic Institutions* 27.

⁸⁶ Williamson *Economic Institutions* 27; see also para 3.3.

⁸⁷ Williamson *Economic Institutions* 29.

⁸⁸ Williamson *Economic Institutions* 30.

since the contract could be terminated which would lead to the supplier having an investment which is no good to him. From the manufacturer's point of view it is also a risky situation if the supplier is his sole provider of vehicle components, since this could lead to opportunistic behaviour on the side of the supplier, which could lead to a situation where the manufacturer is coerced into unfavourable contractual terms to meet his production needs.

One could view non-standard contracting forms, especially in the light of the monopoly scenario sketched above, to be contrary to competition-law principles. However, transaction costs economics view non-standard contracting forms as necessary to protect transactions.⁸⁹

Central to the idea of efficient contracting is that there should be efficient structures within which contractual relations are governed due to the risk of opportunistic behaviour by one of the contracting parties. This is even more important where long-term transactions are envisaged. Again the question arises whether it would be more prudent and economical to enter into these transactions by means of standard contracting in the market or whether to internalise these transactions within the firm.

Williamson reaches the following conclusions in respect of the effect of transaction costs economics:

1. The transaction is the basic unit of analysis.
2. Any problem that can be posed directly or indirectly as a contracting problem is usefully investigated in transaction cost economizing terms.
3. Transaction cost economies are realized by assigning transactions (which differ in their attributes) to governance structures (which are the organizational frameworks within which the integrity of a contractual relation is decided) in a discriminating way. Accordingly:
 - a. The defining attributes of transactions need to be identified.
 - b. The incentive and adaptive attributes of alternative governance structures need to be described.

⁸⁹ Williamson *Economic Institutions* 39.

4. Although marginal analysis is sometimes deployed, implementing transaction cost economics mainly involves a comparative institutional assessment of discrete institutional alternatives - of which classical market contracting is located at one extreme; centralized, hierarchical organization is located at the other; and mixed modes of firm and market organization are located in between.
5. Any attempt to deal seriously with the study of economic organization must come to terms with the *combined* ramifications of bounded rationality and opportunism in conjunction with a condition of asset specificity.”⁹⁰

What can be deduced from the above is that contracting needs to be efficient from a cost perspective and the question then becomes how a person or firm ensures that he or it contracts efficiently. Point four of Williamson’s abovementioned summary then becomes crucial. How does a business organise itself to operate efficiently and therefore contract efficiently?

3.7 Vertical integration

When transactions become long-term in nature, vertical integration becomes an attractive and viable option. According to Williamson vertical integration has the advantage that changes can be effected in a structured manner.⁹¹ Furthermore, its attraction lies in the fact that there is no need to consult or to renegotiate inter-firm transactions since control would be exercised from the top to the bottom by means of effective management measures to ensure compliance on a lower level within the firm. Since there is for all intents and purposes a single proprietor on both sides of a transaction, profit can, theoretically speaking, be maximised. Williamson avers that adjustments can be made as frequently as desired to maximise profits within a single firm. Adaptations can be readily made in respect of, for example, quantity and price of products without the need to renegotiate the transaction as would be the case in a standard market transaction where conditions may have forced the parties to re-evaluate the terms of their agreement in respect of quantity and price.

⁹⁰ Williamson *Economic Institutions* 41-42.

⁹¹ Williamson *Economic Institutions* 78.

It was mentioned earlier that vertical integration can be viewed from two perspectives. On the one hand, it could be done to create a monopoly, or on the other hand it could constitute an attempt to contract efficiently and to limit transaction costs.⁹²

Williamson quotes the following extract from Kleindorfer and Knieps⁹³ regarding the purpose of vertical integration:

“The most popular [explanation] has been that when economies of scope between successive stages due to technological organizational interrelationships are strong enough, these activities should be provided under joint ownership. Other arguments for Vertical Integration have been the avoidance of factor distortions in monopolized markets; uncertainty in the supply of upstream goods with the consequent need for information by downstream firms; and the transfer of risks from one section of the economy to another. Furthermore, it has been pointed out that transaction costs might create important incentives for vertical integration.”⁹⁴

There is an argument that vertical integration is based upon technological advances which have been made in industry. Such technological advances allowed the integration of processes from the raw material stage of a product up to its end stage which could even include the sale stage.⁹⁵ Williamson is, however, of the opinion that vertical integration is rather the result of the need for transaction costs economics.⁹⁶ Although technological advances have made vertical integration easier, ultimately the reason for vertical integration is to off-set market transactions with their inevitable variable cost implications by integrating those market transactions within the firm to save on the transaction costs involved.

According to Williamson, asset specificity is also a fundamental reason for vertical integration. Were asset specificity not a factor, transactions could readily be entered into effectively in the market place. However, the more asset specificity develops the more the parties to a transaction, especially the procurer, realise that internal organisation may

⁹² See paras 3.3 and 3.6 above as well as Williamson *Economic Institutions* 86

⁹³ Kleindorfer & Knieps “Vertical Integration and transaction-specific sunk costs” (1982) *European Economic Review* 19 71-87.

⁹⁴ Williamson *Economic Institutions* 85-86, internal references omitted.

⁹⁵ Bain *Industrial Organization* (1958) 1.

⁹⁶ Williamson *Economic Institutions* 87.

be more efficient than standard market transactions. The decision to enter into transactions in the market or to internalise them is then determined, on the one hand, by the difference in governance costs associated with each of the two options. On the other hand, economies of scope also play a role.⁹⁷ But the more important factor is the efficiency of the governance structures of transactions within a firm. To be efficient, however, the governance structures which are created to integrate the various non-standard transactions within a firm need to be controlled by efficient and effective management control by the owner/parent company.⁹⁸

3.8 Agency costs and transaction costs

The M-form organisation has been referred to above.⁹⁹ In this format an enterprise organises itself based on the products which it produces or on the regions where it operates. According to Williams these units are called profit centres which are designed to overcome agency costs.¹⁰⁰ Williams further mentions that these costs are the counterpart of transaction costs within an enterprise and defines these costs as “the costs of negotiating and enforcing agency arrangements.”¹⁰¹ Agency costs have been explained as follows:

“In most agency relationships the principal and the agent will incur positive monitoring and bonding costs (non-pecuniary as well as pecuniary), and in addition there will be some divergence between the agent’s decisions and those decisions which would maximize the welfare of the principal. The dollar equivalent of the reduction in welfare experienced by the principal due to this divergence is also a cost of the agency relationship, and we refer to this latter cost as the ‘residual loss.’ We define agency costs as the sum of:

- (1) the monitoring expenditures by the principal,
- (2) the bonding expenditure by the agent,
- (3) the residual loss.”¹⁰²

⁹⁷ Williamson *Economic Institutions* 90.

⁹⁸ See Williams *Corporate Groups* in respect of the management dilemma, para 3.5.

⁹⁹ Para 3.5.

¹⁰⁰ Williams *Corporate Groups* 42.

¹⁰¹ Williams *Corporate Groups* 42.

¹⁰² Williams *Corporate Groups* 42 with reference to Jensen & Meckling “Theory of the Firm Managerial Behavior, Agency Costs and Capital Structure” (1976) *Journal of Financial Economics* 3 308.

One of the most common forms of agency costs is the costs to get managers to function as representatives of the shareholders of a company. Within the context of the M-form enterprise the applicable agency costs are the costs involved to get all the managers within the enterprise as a whole to achieve the most beneficial economic outcome for the enterprise.¹⁰³ The ultimate goal is therefore to achieve maximum efficiency within the whole enterprise, and to this end all the separate entities within the enterprise will have to cooperate and coordinate their activities for the greater good of the enterprise as a whole.

3.9 Analysis and criticism of the transaction costs approach

This chapter attempted to demonstrate that a group of companies is a firm and thus could be a single economic unit. Although it would appear that economists do not deem a study of what a firm is as crucial but treat it as a given, the insights of Coase are still prevalent today and influenced a number of economists who have done research on the internal organisation of a firm. It is clear that a group of companies falls within the vertical hierarchal structure of the firm and is mainly created to limit transaction costs which would otherwise have arisen and had to be paid in terms of external contracts with third parties, where such parties are not controlled by the grantor of such contracts. Although the agency costs may be problematic, ultimately the benefits of internalising the operations of a firm outweigh the disadvantages.

The transaction costs approach has nevertheless been subjected to criticism. Anderson¹⁰⁴ argues that the neoclassical economic analysis of companies, as one of a nexus of contracts, leads to an analysis where the separate entity of the company yields to an analysis where the focus is on inputs and the facilitation of express and implied contracts. Shareholders and creditors are merely factors of production and this leads to an analysis that company law is only interested in economic efficiency and not reality.¹⁰⁵ She regards this school of economic thought to be insufficient as a determinant of company law since the focus is purely on transaction costs and efficiency, and not on the equitable

¹⁰³ Williams *Corporate Groups* 42.

¹⁰⁴ Anderson "Creditor's rights of recovery: Economic Theory, Corporate Jurisprudence and the role of fairness" 30 *Melbourne University Law Review* (April 2006) 1.

¹⁰⁵ Anderson *Corporate Jurisprudence* 7.

distribution of the gains made by each party to the contract, namely creditors on the one side and the company on the other.¹⁰⁶

The aim of the economic analysis of the company is to determine whether efficiency exists as shown above.¹⁰⁷ The Kaldor-Hicks analysis does not require the winners to compensate those who are worse off after the bargain, only that there has been efficiency.¹⁰⁸ When the Kaldor-Hicks analysis is used to determine whether there is efficiency where the resources of the company are distributed or arranged in such a manner that the advantage to those who are better off exceeds the disadvantage for those people who are worse off, it appears that there is efficiency.¹⁰⁹ Creditors of companies which fail may therefore be without any remedy against shareholders due to the principle of limited liability, although there was still efficiency in the bargaining between the contractual parties; the parties being the creditors, on the one side, and the company, on the other side.

3.10 Case law recognising the economic reality of groups

The main English case which has given some recognition to a group of companies as a single economic entity is *DHN Food Distributors Ltd v Tower Hamlets London Borough Council*, *Bronze Investments Ltd v Tower Hamlets London Borough Council* and *D.H.N. Food Transport Ltd v Tower Hamlets London Borough Council*.¹¹⁰ In that case the plaintiffs formed a group of companies. Bronze Investments Ltd (“Bronze”) and DHN

¹⁰⁶ Anderson *Corporate Jurisprudence* 7.

¹⁰⁷ Para 3.6.

¹⁰⁸ Also known as the wealth maximization theory after the work of Lord Nikolas Kaldor and Sir John Hicks. See Stephen *The Economics of the Law* (1988) 57-60 who expresses the criterion as follows: “A proposal for a change in the economy should be undertaken if those who are better off by it *could* so compensate those made worse off by it that the latter would be as well off as before the change (in their own eyes) and the former still be better off (in their own eyes).” The compensation is, however, hypothetical and does not have to be paid. See also Posner *Economic Analysis of Law* 6ed (2003) 13. In contrast to Kaldor-Hicks efficiency is Pareto efficiency in terms whereof efficiency is only obtained if one party is better off without the other party being worse off. See Stephen *Economics of the Law* 42. It would appear that the Kaldor-Hicks criterion is the generally preferred criterion. In this respect see Stephen *Economics of the Law* 56.

¹⁰⁹ Anderson *Corporate Jurisprudence* 10.

¹¹⁰ *DHN. Food Distributors Ltd v Tower Hamlets London Borough Council*, *Bronze Investments Ltd v Tower Hamlets London Borough Council* and *DHN Food Transport Ltd v Tower Hamlets London Borough Council* [1976] 1 WLR 852.

Food Transport Ltd (“Transport”) were the wholly owned subsidiaries of DHN Food Distributors Ltd (DHN).

The business of the group was to import groceries and to distribute these groceries to shopkeepers. In due course private individuals could purchase these groceries at the warehouse of the group. Problematic in this instance was the fact that the business of the group was owned by DHN, the holding company, Bronze owned the land on which the warehouse was situated and Transport owned the vehicles which were used to distribute the groceries to shopkeepers from the warehouse.

In 1969 Tower Hamlets London Borough Council made a compulsory acquisition order for the land on which the warehouse of the group was situated to build houses. It went through the necessary procedures and then gave the required notices to the group to vacate. The issue in this case was the compensation payable to the owner of the land. Had the land and the business had one owner, the owner would have been entitled to compensation based on the value of the land and, secondly, compensation based on the disturbance in having its business closed down. The acquiring local authority denied that it owed the group any compensation for the disturbance for the business closing down since the business of the landowner was not disturbed. The business according to the local authority belonged to DHN and not to the landowner, Bronze. The argument was that since DHN and Transport had no interest in the land, they were not disturbed.¹¹¹

One odd thing about the decision was the fact that the group had sufficient time from the moment they first became aware of the possible compulsory acquisition of the land in question and the eventual acquisition to transfer the property from Bronze to DHN without having to pay any stamp duty. The group failed to do so.¹¹² This was, however, not important to the court. Lord Denning held that the fact that the three companies were

¹¹¹ 858.

¹¹² 858.

in fact one did not necessitate the need “to go through a conveyancing device to get [the compensation].”¹¹³

DHN instituted legal action against the defendant and based its action on three grounds of which the important one was the averment that the court should pierce the corporate veil and treat DHN as the owners of the land despite the fact that it itself chose the form of three separate entities to conduct business.

Lord Denning referred to Gower¹¹⁴ who mentioned that there were instances where the separate juristic personalities of companies in groups were ignored and recognition was given to the economic reality of that group as a single legal entity. Lord Denning continued by looking at wholly owned subsidiaries which were “bound hand and foot” to the holding company and had to act as directed by the holding company.¹¹⁵ He also referred to *Harold Holdsworth & Co v (Wakefield) Ltd v Caddies*¹¹⁶ (without providing any details or reasons as to the reason for the referral) as authority and held that the three companies before the court *in casu* were partners in a partnership and “should not be treated separately so as to be defeated on a technical point.”¹¹⁷ He therefore held that the three companies should be treated as one and that the holding company, DHN, was the one which was entitled to claim compensation for the disturbance.

Lord Goff in a concurring judgment, however, made it clear that he agreed with the Lord Denning solely on the facts at hand and that piercing would not be allowed every time that there was a group of companies before the court.¹¹⁸ Goff LJ also referred in more detail to the *Harold Holdsworth* case¹¹⁹ where Lord Reid held that:

“It was argued that the subsidiary companies were separate legal entities each under the control of its own board of directors, that in law the board of the appellant company could not assign any

¹¹³ 860. See also *Cape Pacific Ltd v Lubner Controlling Investments (Pty) Ltd and Others* 1995 4 SA 790 (A) and *Hülse-Reutter and Others v Gödde* 2001 4 SA 1336 (SCA), para 2.7.2 above, regarding the availability of the piercing the veil remedy if there is another remedy available.

¹¹⁴ Gower *Modern Company Law* 3ed (1969) 216, 860 of the case.

¹¹⁵ 860.

¹¹⁶ *Harold Holdsworth & Co v (Wakefield) Ltd v Caddies* [1955] 1 W.L.R. 352.

¹¹⁷ 860.

¹¹⁸ 861.

¹¹⁹ 861.

duties to anyone in relation to the management of the subsidiary companies and that therefore the agreement cannot be construed as entitling them to assign any such duties to the respondent.

“My Lords, in my judgment this is too technical an argument. This is an agreement in *re mercatoria* and it must be construed in light of the facts and realities of the situation. The appellant company owned the whole share capital of British Textile Manufacturing Co. Ltd. and under the agreement of 1947 the directors of this company were to be the nominees of the appellants. So, in fact, the appellants could control the internal management of their subsidiary companies, and, in the unlikely event of there being any difficulty, it was only necessary to go through formal procedure in order to make the decision of the appellants' board fully effective.”¹²⁰

On the facts and with further reference to other case law,¹²¹ Goff LJ also held that he had to look at the business realities of the situation and not at the strict narrow legal rules.¹²²

Shaw LJ wrote a concurring judgment in which he stressed the fact that the directors were the same people in all three companies and that all three had a significant interest in the property where the business was conducted. There was according to him “one completeness of identity” and “one community of interests” between DHN and Bronze.¹²³

3.11 Conclusion

It has been shown in this chapter that a group of companies can constitute an economic unit and in effect be one entity due to reasons of efficiency. Efficiency implies that there are winners and losers and that the winners do not have to compensate the losers. A firm is therefore often better off to internalise its operations by means of the creation of vertical or horizontal independent structures than to conclude independent contracts in the market. This has been an important result in light of the conclusions in chapter two, where it has been shown that the historical justification of limited liability in respect of groups is suspect and could be considered to be a historical accident. This, the doubt in respect of the economic efficiency of limited liability in respect of delictual liability as

¹²⁰ 367 of the actual case and 861 of *DHN*.

¹²¹ *Scottish Co-operative Wholesale Society Ltd v Meyer* [1959] AC 324, [1958] 3 All ER 66, [1958] 3 WLR 404 and *Merchandise Transport Ltd v British Transport Commission* [1962] 2 QB 173.

¹²² 862.

¹²³ 867.

indicated in chapter two¹²⁴ and later in chapter six¹²⁵ and the conclusions in this chapter, namely that a group of companies can form one single economic entity, create sufficient reason for a re-evaluation of the doctrine of limited liability where company groups are involved. Cumulatively the abovementioned arguments present a strong argument that the law as it stands in respect of groups can be considered to be outdated. From a case law perspective the *DHN* case provided brief credibility to a single unit argument. However this case was not generally followed, its effect was short lived and it was ultimately rejected in *Adams v Cape Industries plc*.¹²⁶ The question arises again whether the *ratio decidendi* should not be reconsidered given its lucidity and the fact that the court gave effect to a *de facto* situation which existed.

In the light of the conclusions which have been reached above it becomes necessary to investigate a system which, on face value, recognises the reality of a group of companies in legislation. The aim of the investigation of such a system in the next chapter, namely the German Enterprise law, will be to determine how it gives effect to the economic reality of groups and whether it is an effective system to follow and implement.

¹²⁴ Para 2.5 above.

¹²⁵ Para 6.4 below.

¹²⁶ *Adams v Cape Industries Plc* [1990] Ch. 433 538. See also chapter 6 below.

Chapter 4

The German approach to company groups

4.1 Introduction

In the previous chapters it has been shown that the principle of limited liability in respect of company groups is suspect from a historical and economic perspective. Despite the suspect nature of the limited liability principle the legislature and judiciary in South Africa, and other common-law jurisdictions, have been inconsistent in their attempts to address company groups and have usually failed to acknowledge the single unit reality behind groups.¹ It was also shown that from an economic perspective there are plausible arguments justifying an inference that a group of companies could be considered to be a single entity in appropriate circumstances.

This chapter will focus on possible statutory options which could be explored to regulate corporate groups better. The focus will be on German enterprise law which is the most advanced system in respect of permitting corporate groups to operate as single economic enterprises. As a *quid pro quo*, however, there is enhanced protection for creditors and any minority shareholders.

4.2 The principle of limited liability in German law

Before investigating German enterprise law on corporate groups as a single economic unit, the German system in respect of business enterprises needs to be briefly explained. For the purposes of this dissertation the more important entities with juristic personality are the *Aktiengesellschaft*,² a company with share capital which is usually listed; the *Kommanditgesellschaft auf Aktien*, a public limited partnership by shares; and the *Gesellschaft mit beschränkter Haftung* (GmbH), a company which is comparable to a private company.

¹ See the next three chapters.

² The term is usually translated into English as a “stock corporation”. In the light of the fact that South African company law does not use this term the German term will be used throughout.

Modern company law as it is understood in the common-law system also only appeared in Germany in the nineteenth century, especially with the advent of the Industrial Revolution. Merchant guilds existed since the middle ages but, unlike England, there were not many chartered companies. The lack of chartered companies could be explained by the lack of access to the ocean which was an impediment to strong federal states of the then Germany like Bavaria and Saxony, the weakness of the central German “government” and the Thirty Year War.³ At the end of the Thirty Year War, Brandenburg became a dominant power in the north, replacing Saxony and also acquired access to the ocean through its acquisition of East Pomerania.⁴ Despite the political instability in Germany, Frederick William of Brandenburg, who reigned as elector over Brandenburg-Prussia from 1640 to 1688,⁵ was determined to form chartered companies, not only for trade purposes but also to found colonies.⁶ Frederick William was succeeded by Frederick III whose status as elector changed to King in 1701. Following his coronation Frederick III became King Frederick I.⁷ Frederick I reigned over Prussia until 1713 and was then succeeded by King Frederick William I.⁸

The legal basis of companies in the seventeenth and eighteenth centuries is not entirely clear, since there was no enabling legislation for the creation of such companies. The basis was apparently the granting of charters by the monarch, like the chartered companies in England. Without these charters no company with a share capital was possible.⁹

Internally the companies issued shares which were transferable by means of cession. The companies of this era were under the control of the members’ meeting. There were directors who managed the company but they were subject to the control of the members’

³ Gmuer "Die Emden Handelscompagnien des 17. und 18. Jahrhunderts" in Hefermehl, Gmuer & Brox (eds) *Festschrift fuer Harry Westermann* (1974) 167.

⁴ Rodes *Germany: A History* (1964) 173.

⁵ Rodes *Germany* 195.

⁶ Gmuer *Die Emden Handelscompagnien* 172. In this regard companies like the Kurbrandenburgisch-Ostindische Gesellschaft were established in the late 1640s and the Brandenburgisch-Afrikansche Compagnie in 1682 respectively.

⁷ Rodes *Germany* 197.

⁸ Barraclough *The Origins of Modern Germany* (1984) 399.

⁹ Gmuer *Die Emden Handelscompagnien* 182.

meeting. The two-tier board system of modern Germany was unknown in the era under discussion.¹⁰

Frederick II¹¹ reigned in Prussia from 1740 to 1786. He encouraged trade and also embarked on a programme of colonisation.¹² In the light of his programme to promote enterprise, Frederick the Great issued numerous charters in Prussia to companies, which enjoyed certain privileges like exclusive trade, in the second half of the eighteenth century. According to Gmuer, Frederick II was most impressed by the well known work by Adam Smith¹³ and as a consequence did not issue any more charters with exclusive rights to companies.¹⁴

In subsequent years further charters were nevertheless issued with certain privileges, barring exclusivity. In 1843, however, the Prussian *Aktienrecht*¹⁵ was codified and this ended the charter system. The incorporation of a company needed state approval as was the case in England at around the same period.¹⁶

The Prussian Act of 1843 also granted limited liability to the members of companies which sought incorporation.¹⁷ Initially, prior to the Prussian *Aktienrecht*, limited liability seems to have been a secondary reason for the formation of companies.¹⁸ The Prussian *Aktienrecht* was enacted a few decades after the French *Code de Commerce*.¹⁹ The French Code specifically provided for limited liability²⁰ and was the first to provide for the company in the form that would be recognisable by the modern company lawyer.²¹

¹⁰ Gmuer *Die Emden Handelscompagnien* 188. For the internal organisation and privileges which were enjoyed by these “by monarch chartered companies” see Gmuer *Die Emden Handelscompagnien* 186–196.

¹¹ Frederick the Great.

¹² Sheehan *German History 1770-1866* (1989) 67.

¹³ “An inquiry into the nature and causes of the wealth of nations” in 1766 which was strongly critical of the privileges enjoyed by the English maritime chartered companies.

¹⁴ Gmuer *Die Emden Handelscompagnien* 196.

¹⁵ The law of shares.

¹⁶ Gmuer *Die Emden Handelscompagnien* 197 and see para 2.2.1 above for the discussion of the development of English company law .

¹⁷ Boesselmann *Die Entwicklung des deutschen Aktienwesens im 19. Jahrhundert* (1939) 70.

¹⁸ Lehmann *Die geschichtliche Entwicklung des Aktienrechts* (1968) original edition (1895) 24.

¹⁹ Code de Commerce of 10 September 1807.

²⁰ Section 32.

²¹ Boesselmann *Entwicklung des deutschen Aktienwesens* 61.

One should be mindful of European history however. At that stage France controlled the area west of the Rhine following the Basel Peace Accord in 1795.²² Parts of modern Germany therefore were already acquainted with company law with the concomitant limited liability in 1807. In Prussia concessions or charters were still the only means through which companies could be formed. Prussia, however, gained control of the Rhine area in 1815. German commercial law, however, only replaced French commercial law there in 1862.²³

It would appear from the available literature that limited liability was not treated as essential in the build up to the acceptance of the *Code de Commerce* or the Prussian *Aktienrecht*. The reasons could be twofold: either due to the fact that other advantages of incorporation were regarded as more important, or the fact that on continental Europe the *société en commandite*, a partnership, was already known and since such an entity conferred limited liability to a degree, limited liability was not something completely foreign.

4.3 German enterprise law prior to 1965

According to Dettling²⁴ four phases can be distinguished in the development of the German “group entity” or law relating to company groups, hereafter referred to as enterprise law. These phases are firstly the period commencing during the 1870s, secondly the Weimar Republic period, thirdly the period of national socialism and then lastly the period after the Second World War.²⁵

4.3.1 The initial period

The initial period after the enactment of the Prussian *Aktienrecht* was known as the concession era when companies were subject to very strict control.²⁶ The fear of the

²² Rodes *Germany* 255.

²³ Allgemeine deutsches Gesetzbuch of 1862.

²⁴ Dettling *Die Entstehungsgeschichte des Konzernrechts im Aktiengesetz von 1965* (1997). This section will be based essentially on the work of Dettling which was the only accessible source available.

²⁵ Dettling *Entstehungsgeschichte* 49.

²⁶ Grossfeld *Aktiengesellschaft, Unternehmenskonzentration und Kleinaktionär* (1968) 122 who puts it thus “*Man sah in der Aktiengesellschaft eine Institution, die so gefährlich schien, dass ihr von Staats wegen entgegenzuwirken, zumindest aber ihre Errichtung in jedem einzelne Falle von einer Staatsgenehmigung abhængig*

political establishment was that the civil population would, by means of associations with share capital, become a secondary institution which could even compete with the state.²⁷ This fear was also due to the recent French revolution and the uncertainty about this new creature in the form of a company with a share capital.²⁸ This fear was replaced by the fear of the lack of competition and that small enterprises could be usurped by this new way of conducting business.²⁹ The public needed protection from abuse and since there was no personal liability, the State had to make sure that the company had sufficient funds to satisfy creditors before it allowed incorporation. The grant of incorporation was therefore a concession from the State. On the other hand, there was the perception that companies with strong financial means could become a threat to the State.³⁰ It would appear that the State was of the opinion that economic growth should be under control of the State and that the State should be the ideal institution to protect persons who had an interest in a company.

There was a boom in the incorporation of companies, especially with the advent of the Industrial Revolution, despite the best efforts of the State to make the company as unattractive as possible. Especially in the railway and mining industries there was a steady growth in the incorporation of companies.³¹ This coupled with the advent of *laissez faire* as well as the recognition that creditors and shareholders were not necessarily protected by the sometimes draconian rules for incorporation led to the demise of the concession theory.³² The acceptance of the ADHGB³³ in 1861 also led to the challenging of the concession theory. Much debate ensued amongst the different provinces in respect of the continued existence of the concession approach. This led to a compromise, namely that the provinces could decide whether they wanted to continue

zu machen und sie einer dauernden Regierungskontrolle zu unterwerfen sei.“ (The share company was seen as an institution which could be dangerous. To counter this it needed state approval to be incorporated and was subject to continuous state control).

²⁷ Grossfeld *Aktiengesellschaft* 123 with reference to Boesselmann *Entwicklung des deutschen Aktienwesens*.

²⁸ Grossfeld *Aktiengesellschaft* 123.

²⁹ Grossfeld *Aktiengesellschaft* 123 who refers to Vogt *Theorie der Handelsgesellschaften* 538 who said that competition could be stifled by this form of business. Whether the greater good would be served by this form of business would depend on a case by case basis but the state should determine this question and not the company.

³⁰ Grossfeld *Aktiengesellschaft* 125.

³¹ Generally see Grossfeld *Aktiengesellschaft* and Boesselmann *Entwicklung des deutschen Aktienwesens*.

³² Grossfeld *Aktiengesellschaft* 132.

³³ Allgemeines deutsches Handelsgesetzbuch.

with the concession approach or not. Civil pressure on the state also led to the demise of the concession approach.³⁴

The most important step to get rid of the concession approach was the adoption of free trade in 1869.³⁵ The normative approach to company law was introduced in 1870 by means of the *Kommanditgesellschaftsgesetz* and the *Aktiengesetz*.³⁶ The state therefore left the internal organisation of a company to the company itself so that the company could determine its own sphere of existence and economic activities.³⁷ This was also in line with the general liberal attitude of that time. The Industrial Revolution stimulated but also forced extensive capital input into firms which consequently pacified the critics of the company with share capital.³⁸ Interestingly enough it was the railways, which, as in the United States,³⁹ again played a dominant role as the frontrunner of companies with a very large share capital.

However, unlike the United States, a recession struck Germany in the mid-1870s after the initial boom following the successful war with France.⁴⁰ The recession led to warnings of monopolies since the primary issue at stake was survival. Competition between companies became secondary. This reality led to companies having to merge or be taken over by other bigger companies. Cartels also became a regular feature and these cartels were also justified before the *Reichsgericht*.⁴¹ A fierce critic of possible monopolies was Rudolf von Jhering⁴² but his, and other, criticism were ignored when in certain industries,

³⁴ Grossfeld *Aktiengesellschaft* 135.

³⁵ Gewerbeordnung des Norddeutschen Bundes of 21 June 1869, 245 of the BGBl des Norddeutschen Bundes.

³⁶ 11 June 1870.

³⁷ Grossfeld *Aktiengesellschaft* 141.

³⁸ Dettling *Entstehungsgeschichte* 50.

³⁹ See para 2.2.4.1.

⁴⁰ Grossfeld *Aktiengesellschaft* 144.

⁴¹ The German High Court of the era as referred to by Dettling 50.

⁴² Grossfeld *Aktiengesellschaft* 144 who refers to the following quote by Jhering: “*Unter den Augen unserer Gesetzgeber haben sich die Actiengesellschaften zu organisierten Raub- und Betrugsanstalten verwandelt, deren geheime Geschichte mehr Niedertraechtigkeit, Ehrlosigkeit, Schurkerei in sich birgt, als gar manches Zuchthaus, nur daß die Raeuber und Betruerger hier statt in Eisen in Gold sitzen.*“ (The share companies changed to organised robbery and fraud institutions under the noses of the legislature, whose secretive history hides more dishonest and skulduggery than many a brothel. Only the robbers and fraudsters are sitting satisfied in gold and iron.)

like the mining of potassium, cartels were granted privileges and the dangers of cartels were ignored.⁴³

The introduction of the freedom to incorporate a company was not only important in respect of the building of cartels but also important in respect of the formation of enterprises.⁴⁴ Before the existence of enterprise law can be investigated the same question needs to be asked as in the case of the United States,⁴⁵ namely when did it become possible for one company to hold shares in another in Germany?

It was possible from the 1840s for companies to hold shares in other companies. Initially it was banks which held shares in other companies.⁴⁶ Grossfeld⁴⁷ refers to Renaud,⁴⁸ who declared that by the mid-1860s it was possible for a company to be a member of another company. Case law from 1877 also shows that holding companies already existed at that stage.⁴⁹ By the end of the nineteenth century the company as juristic person had in effect obtained all the rights that a natural person could have. Whether it was ever intended that companies could hold shares in other companies seems to be answered in the negative by the available literature.⁵⁰

Enterprises, or groups of companies, were unknown phenomena during the formative years of the German *Aktiengesetz*. The promotion of competition between companies was probably also unknown at that stage since competition would usually be stifled by big conglomerates which owned numerous subsidiary companies. However, with the introduction of the Sherman anti-trust legislation in the United States of America at the end of the nineteenth century,⁵¹ German legal scholars started to point out the potential hazards associated with company groups or where companies are allowed to hold shares

⁴³ Dettling *Entstehungsgeschichte* 51.

⁴⁴ Dettling *Entstehungsgeschichte* 53.

⁴⁵ See chapter 2 para 2.2.4.

⁴⁶ Grossfeld *Aktiengesellschaft* 149.

⁴⁷ Grossfeld *Aktiengesellschaft* 149.

⁴⁸ *Actiengesellschaften*, 1. Auflage, Leipzig 1863, 343.

⁴⁹ Grossfeld *Aktiengesellschaft* 150 with reference to the ROHG Urteil 12.5.1877, ROHGE 22 277.

⁵⁰ See Grossfeld 150 and the criticisms he refers to of Landau, Radcliff and Ribble.

⁵¹ See chapter 2 para 2.2.4 n37.

in other companies.⁵² Grossfeld refers to railway companies which cooperated, to a large degree, with each other without apparently creating a legal nexus. The consequence was that in theory companies were competing with each other but as a matter of fact, one was under the control of another.

Legal scholars started to formulate problems which groups of companies could cause. Liefmann⁵³ recognised that control over a company could be achieved while having very little capital. The risk of failure therefore was remote since the investment in the company is very small. The risk of the holding company could however be passed to this subsidiary and should it have been a shrewd investment, the holding company would benefit from it. Liefmann also recognised the political impact of the concentration of power in powerful groups, albeit at the political national level, whereas today the concentration of power transcends national borders in the era of globalisation.⁵⁴

Klein recognised that minority shareholders could be prejudiced by these holding companies since individuals would be outmuscled by organised capital whose sole concern was its own interests.⁵⁵ Mezel argued that the legislature needed to amend the *Aktiengesetz* and regulate the concentration of power by groups to protect not only shareholders and creditors but also the public interest.⁵⁶ On the other hand there were other authors like Isay who were of the view that the creation of holding companies and subsidiary companies was a natural progression of the economic order. He saw the separation of the holding company and its subsidiary as formalistic and according to him, it was a single enterprise and should be recognised by the law as such.⁵⁷

⁵² Grossfeld *Aktiengesellschaft* 151 with reference to Aschrott, Menzel, Jenks, Kohler and Kempin. Kempin viewed it as anomalous that one company could determine the business affairs of another company. Menzel focused on the economic impact which groups of companies could have. For him it was conceivable that the economic impact would be greater than the legal impact. This to a degree certainly holds true although Menzel failed to see that the economic impact which groups of companies had, was to some extent due to the fact that the law could not recognise the group as one entity. The law therefore was responsible for creating groups, an opportunity which entrepreneurs would naturally seize should it benefit them economically.

⁵³ Grossfeld *Aktiengesellschaft* 152 with reference to Liefmann *Die Unternehmensformen* (1912) 112.

⁵⁴ Grossfeld *Aktiengesellschaft* 153.

⁵⁵ Grossfeld *Aktiengesellschaft* 153.

⁵⁶ Grossfeld *Aktiengesellschaft* 154 with reference to Menzel *Verhandlung des 26 DJT* (1902) 3 288.

⁵⁷ Grossfeld *Aktiengesellschaft* 157 with reference to Isay *Das Recht am Unternehmen* (1910).

Despite the reservations referred to above, groups of companies mushroomed in the latter half of the nineteenth century. At this time a new entity was also created by the German legislature, namely the GmbH.⁵⁸

According to Dettling the establishment of groups led to market domination through the elimination of competition as well as to secure the raw materials which were needed for production and simultaneously securing the point of delivery.⁵⁹ It was mainly big family businesses which formed the group enterprises, whereas the larger public enterprises preferred the establishment of cartels.⁶⁰

The German legislation initially still treated the share capital company as one separate entity and initial amendments were in respect of the incorporation of companies as well as the protection of creditors of the company. Furthermore the members' meeting was the more important organ of the company and not the board of directors. The majority rule principle also became more firmly entrenched as a principle which reduced the position of minority shareholders in the company.⁶¹

The German courts did not have any principled opposition to companies holding shares in other companies. They did, however, set certain boundaries. Decisions of the company could for example not be abdicated to third parties; the third party being the holding company. The implication is, however, that should a party be within a company, remembering that the members' meeting was the more important organ, the holding company could or would effectively decide what the subsidiary could or could not do.⁶² Since the majority vote was controlled by the holding company any damages which were caused by the board of directors could be ratified by the members' meeting.

An examination of the early scholarly works in respect of groups shows that the biggest concern was the lack of competition which would ensue. Problems that are still

⁵⁸ GmbH Gesetz of 20 April 1892. See RGBI 477.

⁵⁹ Dettling *Entstehungsgeschichte* 52.

⁶⁰ Dettling *Entstehungsgeschichte* 52.

⁶¹ Dettling *Entstehungsgeschichte* 53.

⁶² Dettling *Entstehungsgeschichte* 54.

encountered today, like the position of creditors of entities within the group and the sometimes unenviable position which directors of the various entities in the group find themselves, were not on the agenda at that early stage of company law. The minority was subject to the will of the majority, who could ratify any act which caused harm, even where minority interests were at stake or prejudiced. Economic expediency was therefore at the forefront during the first phase of the German enterprise law.⁶³ The dangers which a number of commentators alluded to or warned against were not heeded, most probably due to the shape of the German economy in the latter half of the nineteenth century, the liberal atmosphere of the early years where the freedom to associate in any legal manner was respected and the formalistic approach by the German courts, when confronted by groups of companies.

4.3.2 The second phase

The second phase of German enterprise law started at the end of the First World War, in 1918, and ended just before the rise of National Socialism in Germany in 1933. According to Dettling enterprises came more and more to the fore and in a sense started to replace cartels as dominant forces in the German economy after the end of the First World War.⁶⁴ By 1932 nearly 50% of companies in Germany were part of a group of companies in one way or another. It would appear that, like the first phase, due to the heavy burden of debt after the war and a recession, many companies could only survive as part of a group enterprise.⁶⁵ Dettling further mentions that the enterprise idea promoted numerous debates regarding the value of a single enterprise approach. Juristic works of the time focused on accentuating the positives of treating a group of companies as a single entity, but without referring to the possible risks of a single entity. The treatment of groups as single entities became known as the relative theory, because there was no single theory in respect of an enterprise which suited all areas of the law. The area of law therefore determined whether the enterprise would be treated as a single entity or not. Treatment of groups as single entities then ultimately depended on whether this was to

⁶³ Dettling *Entstehungsgeschichte* 55.

⁶⁴ Dettling *Entstehungsgeschichte* 57.

⁶⁵ Dettling *Entstehungsgeschichte* 58.

the advantage of the group.⁶⁶ Tax law was at the forefront in treating company groups as single entities. In this context the mere holding of the majority of shares or votes in another company was sufficient for them to be seen as a single entity.⁶⁷

In the context of company law, it would appear that the courts were also more inclined to treat the group as a single entity where it would be to the advantage of the group, but as separate entities where it was not. The holding company would only be held liable for the debts of the subsidiary in very restricted circumstances.⁶⁸ In respect of contract law the position was largely the same as in company law. Where the contracts were beneficial to the group there was no problem in contracting on behalf of the group.⁶⁹

In general it could be said that the post first world war era was one of legal liberalism in respect of groups. The courts and the legislature seemingly went out of their way to recognise a group entity, if it were to the advantage of a group. However, the single entity approach was applied more restrictively in those cases where treating the group as one entity would be to the disadvantage of the group.

The first phase, discussed above, was seemingly a totally liberal phase where the law recognised the *de facto* existence of the group also formally, although strictly speaking there was no legal basis for such treatment. The existing *Aktiengesetz* did not provide for any recognition of the enterprise as a single entity.

The need for a strong economy was again at the forefront during the second phase to relieve the German national debt due to the economic burden which the terms of the Versailles peace treaty placed on Germany, coupled with the aftermath of the then recent worldwide recession.

⁶⁶ Dettling *Entstehungsgeschichte* 59.

⁶⁷ Dettling *Entstehungsgeschichte* 61 with reference to the German Reichsfinanzhof.

⁶⁸ Dettling *Entstehungsgeschichte* 62 with reference RGZ 142(1934) 219 and Spindler *Recht und Konzern*.

⁶⁹ Dettling *Entstehungsgeschichte* 63.

4.3.3 The third phase

Germany passed a new *Aktiengesetz* in 1937 which gave greater power to the majority shareholders but also expected that companies had to serve the greater good of the population and the State.⁷⁰ It made provision for enterprises as independent entities under certain conditions.⁷¹ It also provided for contracts which the enterprise could enter into as a single entity.⁷²

The 1937 Act again gave significant recognition and protection to enterprises. Dettling refers to an article in the *Frankfurter Handelsblatt* which had the heading; “*Freie Bahn dem Konzernwohl*”.⁷³ Germany thus became the country which allowed the conduct of business in the form of cartels and groups since these were protected by law.⁷⁴

4.3.4 The fourth phase

Post Second World War discussion in Germany in respect of enterprise law was characterised by five schools of thought. These were the *ordoliberalen* or *ordnungsrechtliche* school, the *unternehmensrechtliche* school, the managerial school, the *organisationsrechtliche* or conservative liberal school and the *schutzrechtliche* school.⁷⁵ The three most important schools, which warrant a brief discussion, are the *ordoliberalen* school, *unternehmensrechtliche* school and the conservative liberal school.

The *ordoliberalen* school was in favour of the market economy system and competition between businesses. Should a number of entities position themselves as a single enterprise it would defeat competition in the market place.⁷⁶ Their purpose in respect of the *Aktiengesetz* therefore was to make the creation of enterprises as difficult as possible and by this means prevent the concentration of market or economic power in the hands of a few.⁷⁷ The logic behind this argument is naturally that if the number of enterprises,

⁷⁰ Dettling *Entstehungsgeschichte* 75.

⁷¹ See s 15(1) of the 1937 *Aktiengesetz*.

⁷² S 256.

⁷³ Dettling *Entstehungsgeschichte* 80. “Free rein for the good of the enterprise.”

⁷⁴ See further Dettling *Entstehungsgeschichte* 81.

⁷⁵ Dettling *Entstehungsgeschichte* 89.

⁷⁶ Dettling *Entstehungsgeschichte* 89.

⁷⁷ Dettling *Entstehungsgeschichte* 100.

which consist of multiple companies, possibly with different types of businesses, are prevented or reduced, the more competition there will be.

The *unternehmensrechtliche* school, also known as the neo-socialism school, was not much different from the *ordoliberalen* school and the prevention of the concentration of power was also important to them. Power for them, however, extended beyond economic power and included social and political power. Furthermore, the protection of employees was crucial. State intervention was the only means to achieve this. Private regulation of company law could not solve all the problems associated with large enterprises.⁷⁸

The conservative liberal school was of the view that a big enterprise was at the forefront of economic development which would lead to technological advances and the advancement of the economic position of employees.⁷⁹ The school viewed an enterprise as a logical conclusion of the internal growth of a company and that any attempt to prevent this growth would be contrary to all principles.⁸⁰

4.4 The *Aktiengesetz* of 1965

The above developments culminated in the *Aktiengesetz* of 1965. The *Aktiengesetz* is divided into various books. The law in respect of enterprises is regulated in the third book of the *Aktiengesetz*. In the first book of the *Aktiengesetz*, however, there is provision for what a common-law lawyer would understand as the regulation of a holding company and a subsidiary company. Initially the discussion will focus on the content of the *Aktiengesetz* regarding the regulation of enterprises and thereafter an evaluation of the provisions will be provided.

4.4.1 The first book of the *Aktiengesetz*: Definitions of relevant concepts in respect of enterprises

Section 15 of the *Aktiengesetz* defines connected companies as judicially independent companies, which in relation to each other exist in majority owned enterprises and within

⁷⁸ Dettling *Entstehungsgeschichte* 102.

⁷⁹ Dettling *Entstehungsgeschichte* 116.

⁸⁰ Dettling *Entstehungsgeschichte* 116.

majority participating enterprises as provided for in §16 of the *Aktiengesetz*, independent and controlling enterprises,⁸¹ enterprise businesses,⁸² businesses which are in a reciprocal business relationship with each other⁸³ or in a contractual relationship based on a enterprise agreement with each other.⁸⁴

Section 16 of the *Aktiengesetz* regulates what in South African company law parlance would be the controlling interest which one company has in another. Section 16 of the *Aktiengesetz* provides for *Mehrheitsbeteiligung*.⁸⁵ *Mehrheitsbeteiligung* is present where either one company owns the majority of the shares in another juristic entity or where one company, by means of usually controlling the majority shares in another company, has the majority voting rights in that company. The *Aktiengesetz* provides that shares which are held in a fiduciary capacity or by a dependent company shall be treated as those of the holding company.⁸⁶ The voting rights would therefore follow a similar pattern in that the shares which belong to or controlled by the holding company will carry the concomitant number of votes.⁸⁷

Section 17 of the *Aktiengesetz* regulates dependent and controlling enterprises. Dependency and therefore indirectly section 17, stands central in enterprise law.⁸⁸ The *Aktiengesetz* defines a dependent company as an independent (separate) company over which another company (the controlling company) can directly or indirectly exercise a controlling influence.⁸⁹ Where one company owns the majority shares or has the majority voting rights in another company, within the context of section 16 of the *Aktiengesetz*, it is deemed that the latter company is dependent on the first mentioned company.⁹⁰ One of the consequences of the dependency relationship is that should the dependent company

⁸¹ S 17 of the *Aktiengesetz*.

⁸² S 18 of the *Aktiengesetz*.

⁸³ S 19.

⁸⁴ Ss 291 and 292.

⁸⁵ Literally majority participation or control.

⁸⁶ S 16(4).

⁸⁷ S 16(3) read with s 16(2).

⁸⁸ Emmerich & Habersack *Aktien- und GmbH- Konzernrecht* 3ed (2003) 36.

⁸⁹ S 17(1).

⁹⁰ S 17(2).

hold shares in the controlling company, those shares shall not carry any voting rights.⁹¹ Furthermore it would appear that it is crucial that the controlling company should have the power or the means to subject the dependent company to its will before it will be considered to be a controlling company.⁹²

There are a number of ways in which one company can subject another company to its will and thus control that other company. The control could be legal in nature or factual. Legal control, due to its legal nature, guarantees a more lasting influence.⁹³

Factual control could either be economic or personal and by its nature is more likely to change. For example one company could be dependent on another for its raw materials or for the distribution of its products. Where this relationship or dependency is not formalised in a holding and subsidiary relationship it is entirely dependent on contractual relationships which could be terminated whereas a holding and subsidiary relationship would be a more long-term relationship especially where the holding company and subsidiary company stand in a vertical relationship in the production chain of a product.⁹⁴

There are a number of ways in which one company could control another so as to have factual or legal control. A majority shareholder through its capital investment would naturally be able to exercise control. Concomitant to this would be the fact that a majority shareholder would have the majority voting rights at the members' meeting of the controlled company. Contracts qualifying as enterprise agreements in terms of section 291 of the *Aktiengesetz* could also be entered into to establish or support a situation of control.⁹⁵

Although the first book of the *Aktiengesetz* defines what connected companies are, the substance of the relationship between connected companies is regulated in the third book

⁹¹ S 71d read with section 71b. See also in this regard s 39(1)(a) of the South African Companies Act 61 of 1973.

⁹² Sauermann *Die Haftung des Mutterunternehmens für die Verbindlichkeiten der Tochtergesellschaft nach deutschem und südafrikanischem Konzernrecht* LLD dissertation Münster (1990) 24.

⁹³ Sauermann *Haftung* 25.

⁹⁴ Sauermann *Haftung* 26.

⁹⁵ The control, cession of profits or management contracts provided for in the *Aktiengesetz*.

of the *Aktiengesetz*, which is divided into five sections. The first two sections of the third book of the *Aktiengesetz* are the most important since they regulate the two important forms of group entity which the German legislature chose to recognise, namely contractual and *de facto* groups.

4.4.2 The third book of the *Aktiengesetz*

4.4.2.1 Introduction

The German enterprise law⁹⁶ distinguishes two situations, namely companies which form *de facto* groups and companies which stand in a contractual relationship to each other and form contractual groups. The point of departure in German company law, as in South African law, is that each company is a separate juristic person. The management of a company is also conducted by its board of directors.⁹⁷ The enterprise law as regulated by the *Aktiengesetz* fundamentally contradicts this underlying principle of company law since one company has the power to manage the subsidiary company. The power of a company to manage another company is provided and regulated in the *Aktiengesetz*.⁹⁸

The enterprise law as regulated by the *Aktiengesetz* can be divided into various sections. The first section comprises provisions which common-law jurists would interpret as the building blocks of a group,⁹⁹ namely defining holding companies and subsidiary companies, related companies and connected parties. The second section deals with enterprise agreements, the third section with *de facto* enterprises, the fourth section deals with the integration of a subsidiary company into the holding company and the last section deals with the squeezing out of minority shareholders.¹⁰⁰

⁹⁶ *Konzernrecht*.

⁹⁷ S 76.

⁹⁸ Ss 291-310.

⁹⁹ Ss 15-22.

¹⁰⁰ Emmerich & Habersack *Konzernrecht* 2-3.

4.4.2.2 Enterprise agreements in terms of the *Aktiengesetz*

4.4.2.2.1 Substantive provisions

Contractual enterprises are regulated in the third book of the *Aktiengesetz*.¹⁰¹ Section 291 refers to domination agreements in terms of which a company with shares (a listed company) or a public limited partnership with shares cedes the management of that company (“the dependent company”) to another company, the controlling company.¹⁰² or where such a share company or public limited partnership by shares undertakes to cede all its profits to another company.¹⁰³ Also an undertaking by a company with shares or a limited partnership with shares to conduct business for the account of another entity qualifies as a cession of profits agreement.¹⁰⁴ Should one of two companies, which are not dependent on each other, be managed under single management, without the one company becoming dependent on the other company, such an agreement will not constitute a domination agreement.¹⁰⁵ The controlling enterprise could be any form of enterprise and does not have to be a company with shares or a limited partnership with shares.¹⁰⁶ Furthermore, the controlled companies have to be German incorporated companies. The controlling company does not, however, have to be a German incorporated company and may be a foreign or external company.¹⁰⁷

The cession of profits agreement implies the cession of all profits by a company with shares or a limited partnership with shares. Profits in this context mean all profits of the specific undertaking.¹⁰⁸ The practical importance of this type of agreement lies in its tax implications.¹⁰⁹ The company which cedes its profits has to be a German incorporated company whereas the recipient company may be a German incorporated or external company.¹¹⁰ Unlike the domination agreement the cession of profits agreement can be

¹⁰¹ Ss 291-310.

¹⁰² *Beherrschungsvertrag*.

¹⁰³ *Gewinnabführungsvertrag*.

¹⁰⁴ S 291(1).

¹⁰⁵ S 291(2).

¹⁰⁶ Emmerich & Habersack *Konzernrecht* 111.

¹⁰⁷ Emmerich & Habersack *Konzernrecht* 111.

¹⁰⁸ S 291(1). See also Emmerich & Habersack *Konzernrecht* 124.

¹⁰⁹ Emmerich & Habersack *Konzernrecht* 124 with reference to s 14 of the *Körperschaftsteuergesetz*.

¹¹⁰ Emmerich & Habersack *Konzernrecht* 125.

made operational retrospectively to include the current financial year in which the agreement is entered into.¹¹¹

The consequences of the abovementioned relationships between companies in the same group vary. The mere fact that two companies fall under the auspices of section 16 of the *Aktiengesetz*¹¹² does not necessarily imply that the holding company would be liable for the debts of the subsidiary company.

According to Emmerich and Habersack most enterprises in Germany are *de facto* enterprises and are not formed in terms of a domination agreement.¹¹³ Important further is the question of international agreements where one of the parties is a foreign company. Germany used to follow the *lex situs*, the place where the company had its head office, to determine the nationality of a company.¹¹⁴ Lately, however, the German courts have been looking at the place where the company has been incorporated.¹¹⁵

Two situations have to be distinguished when dealing with agreements which transcend national borders. Firstly, cases where a German company is the controlling company of a foreign company and secondly where a German company is the company under control of a foreign company. In respect of a foreign company under the control of a German company the legal position of the former is subject to the law of the country where the company is incorporated.¹¹⁶ In the second scenario where the controlled company is a company which has been incorporated in Germany, the German company is protected like any other controlled German company under the *Aktiengesetz*.¹¹⁷

Section 292 of the *Aktiengesetz* regulates the position of other enterprise agreements.¹¹⁸

The section regulates the situation where a company binds itself to merge its profits or

¹¹¹ Emmerich & Habersack *Konzernrecht* 126.

¹¹² Para 4.4.1.

¹¹³ Emmerich & Habersack *Konzernrecht* 110.

¹¹⁴ Emmerich & Habersack *Konzernrecht* 118.

¹¹⁵ Emmerich & Habersack *Konzernrecht* 119.

¹¹⁶ Emmerich & Habersack *Konzernrecht* 119, s 293(2) of the *Aktiengesetz*.

¹¹⁷ Emmerich & Habersack *Konzernrecht* 119 and ss 302– 305 of the *Aktiengesetz*.

¹¹⁸ “Other enterprise or business agreements.”

the profits of its individual businesses with the profits of other enterprises or the businesses of other enterprises.¹¹⁹ Partial profit transfer agreements are also regulated in the *Aktiengesetz*.¹²⁰ In terms of a partial profit transfer agreement an enterprise binds itself to another to transfer a portion of its profits or the profits of certain divisions to the other contracting enterprise. *Betriebspacht*¹²¹ and *Betriebsüberlassungsverträge*¹²² are also regulated.¹²³ According to Emmerich and Habersack one of the purposes of this section is to subject enterprise agreements to sections 293 to 299 of the *Aktiengesetz*.¹²⁴

4.4.2.2 Procedural requirements for enterprise agreements

Sections 293 to 299 provide for the procedural requirements which need to be complied with for the conclusion, amendment and termination of the enterprise agreement which can, amongst others, be in the form of a domination agreement as mentioned above. The *Aktiengesetz* requires a 75% majority of the dominated company's shareholders to approve of the enterprise agreement in writing.¹²⁵ Neither the creditors of the dominated company nor the creditors of the controlling company have any say in the matter. One would have assumed that the creditors of the holding company would have had a say in the matter in the light of the fact that there are now more creditors that have to be satisfied and who can influence the payment of their claims. Should the enterprise agreement take the form of a domination agreement or a transfer of profits agreement and the other party to the agreement is an *Aktiengesellschaft* or a *Kommanditgesellschaft auf Aktien*¹²⁶ a 75% majority of that company's shareholders is also required.¹²⁷

The boards of directors of both parties to an enterprise agreement, subject to the requirements of section 293 of the *Aktiengesetz*, have to provide a comprehensive written report in which they have to explain and justify the conclusion of the relevant contract.

The conclusion of the enterprise agreement has to be justified economically as well as

¹¹⁹ S 292(1), the *Gewinngemeinschaft*.

¹²⁰ S 292(2), the *Teilgewinnabführungsvertrag*.

¹²¹ Lease of business agreement.

¹²² Lease of operating facilities agreement.

¹²³ S292(3).

¹²⁴ Emmerich & Habersack *Konzernrecht* 134.

¹²⁵ S 293(1) read with s 293(3).

¹²⁶ A public limited partnership by shares.

¹²⁷ S 293(2).

legally. Furthermore, details have to be provided in respect of the amount of compensation as well as the severance payment for a dissenting or minority shareholder of the dependent company.¹²⁸ One can assume that the purpose of this requirement is to enable the shareholders of the contracting parties to make an informed decision in the light of all the relevant information. The enterprise agreement nevertheless also has to be considered by a *Vertragsprüfer*.¹²⁹ This auditor is appointed by the board of the dependent company or by the court on application of the dependent company to the enterprise agreement.¹³⁰ The contract auditor is in principle a chartered accountant and his duties are set out in the *Aktiengesetz*.¹³¹ The auditor, among other duties, has to report, in writing, whether the compensation or severance payment is adequate.¹³² The relevant shareholders are also entitled to be furnished with copies of the enterprise agreement, the annual financial statements of the contracting parties for the preceding three years as well as the reports of the respective boards and auditors before the annual general meeting at which they are expected to vote on the proposed enterprise agreement.¹³³ The enterprise agreement becomes binding only once it has been entered in the commercial register.¹³⁴

4.4.2.2.3 *The protection of the dependent company, its creditors and minority shareholders*

The *Aktiengesetz* provides for the protection of the dependent company, its creditors and its minority shareholders.¹³⁵ The provisions can be divided into three groups; firstly provisions to protect the company and its creditors, secondly provisions to protect minority shareholders and thirdly the ambit of the powers of the dominating company.¹³⁶

In the first group of provisions the legislature aimed to protect creditors of the dominated company by means of (i) a requirement that a minimum capital reserve amount has to be

¹²⁸ S 293a read with ss 304 and 305.

¹²⁹ A contract auditor in terms of s 293(b).

¹³⁰ S 293c.

¹³¹ S 293d read with ss 319 and 320 of the Commercial Code (*Handelsgesetzbuch*). See also Emmerich & Habersack *Konzernrecht* 196.

¹³² S 293e read with section 293a.

¹³³ S 293f.

¹³⁴ S 294.

¹³⁵ Altmeppen in Kropff & Semler *Münchener Kommentar zum Aktiengesetz* 2ed (2000) 523. Ss 300–307.

¹³⁶ Emmerich & Habersack *Konzernrecht* 270-271.

maintained; (ii) that cover is in place for any annual losses suffered by the dominated company; and (iii) the maximum profit which may be transferred to a controlling company in terms of a transfer of profits agreement; and (iv) a provision providing that the controlling company provides security to the creditors of the dependent company to ensure that they will be paid once enterprise agreement comes to an end.¹³⁷

In the second group of provisions minority shareholders of the dependent company are able to choose between two alternatives. They may either choose to remain shareholders of the dominated company and demand certain capital payments in lieu of dividends they would have received were the company still independent;¹³⁸ alternatively they have the right to leave the company. In the event that they leave the dependent company they can either demand payment of an agreed amount for their shares or demand shares in the holding company in exchange for their shares. Should the holding company also be a subsidiary company of another company the shareholders may demand shares in the ultimate holding company in exchange for their shares in the first-mentioned subsidiary.¹³⁹

The third group of provisions regulates the powers of the controlling company *vis-à-vis* the dependent company are regulated.¹⁴⁰ The controlling company is entitled to give directions to the dependent company if a domination agreement is in place.¹⁴¹ These directions may also be prejudicial to the dependent company in the absence of a contrary provision in the enterprise agreement. As long as these directions are to the benefit of the controlling company or other companies within the group, the dependent company has to comply with these directions. The board of the dependent company may not refuse to follow the directions of the controlling company because they believe that the directions

¹³⁷ Ss 300–303 of the *Aktiengesetz*.

¹³⁸ S 304; See Emmerich & Habersack *Konzernrecht* 317 and Bilda in Kropff & Semler *Münchener Kommentar* 581-582.

¹³⁹ S 305; See Emmerich & Habersack *Konzernrecht* 350-353.

¹⁴⁰ S 308–310.

¹⁴¹ Altmeppen in Kropff & Semler *Münchener Kommentar* 692-693.

are not to the benefit of the controlling company or of other companies within the group structure.¹⁴²

4.4.2.3 *The regulation of factual enterprises in the Aktiengesetz*

The *Aktiengesetz* makes provision for situations where an enterprise agreement in its various options is not present but where one company does exercise control over another.¹⁴³ This concerns the existence of *de facto* enterprises. If no domination or cession of profits agreement exists, the *Aktiengesetz* provides that the holding company may not issue directives to the dependent subsidiary to engage in activities detrimental to its business or to take any business decisions which would be detrimental to the subsidiary, unless the detriment is remedied by the holding company.¹⁴⁴ In the light of the fact that the majority of shareholders will determine the policies of the *GmbH*,¹⁴⁵ this form of company is the preferred option as subsidiary company.¹⁴⁶ If the detriment is not remedied during the financial year in which it was caused it has to be made good at the end of that financial year. Should this not be done the subsidiary will have a claim against the holding company.¹⁴⁷

The board of directors of a subsidiary company has to compile a report within the first three months of a financial year in which the relations of the subsidiary *vis-à-vis* related companies has to be reported, if no domination agreement is in existence. This report has to state all the legal obligations which the subsidiary had incurred in the previous financial year towards the holding company or a related enterprise of the holding company and all the obligations undertaken upon the directive of that holding company, as well as any business decisions undertaken upon the directive of the holding company. The report has to state the performance that had to be given as well as the consideration received by the subsidiary company. The report also has to state which business decisions and measures the subsidiary company undertook upon the directive of the holding

¹⁴² S 308(1) and 308(2).

¹⁴³ Ss 311 – 318.

¹⁴⁴ S 311(1). Emmerich & Habersack *Konzernrecht* 501-504.

¹⁴⁵ S 37 of the *GmbH Gesetz*.

¹⁴⁶ Assmann, Lange & Sethe *The Law of Business Corporations* in Zekoll & Reimann (eds) *Introduction to German Law* 2ed (2005) 166.

¹⁴⁷ S 311(2).

company, the reasons for these decisions and the advantages and disadvantages for the subsidiary company. The report has to state whether the disadvantages have been made good by the holding company and if so, how. The report also has to state whether the rights which the subsidiary obtained have been guaranteed.¹⁴⁸ This report has to be included in the annual report¹⁴⁹ of the subsidiary company.

If the subsidiary company is audited, the auditor has to report to the supervisory board¹⁵⁰ whether the report of the board of directors is correct, that the performance which the subsidiary had to provide was not unnecessarily high or that the detrimental transactions of the subsidiary were remedied by the holding company.¹⁵¹ The board of directors also has to submit the abovementioned report¹⁵² to the supervisory board which has to report to the shareholders meeting. If the company was audited, the supervisory board also has to take a stance on the report of the auditor and report this stance to the shareholders meeting, especially if there are objections against the conclusions which the board of directors reached.¹⁵³ If the subsidiary company has to be audited, the auditor has to participate in the meeting of the supervisory board and report on the material conclusions of his report in respect of the relationship between the company and related companies.¹⁵⁴

A shareholder of the subsidiary company may also approach a court to appoint an auditor to investigate the business relations between the subsidiary and the holding company or other related companies of the holding company. The shareholder may do this under three circumstances, namely where the auditor did not sign off the report of the board of directors as required of him by the *Aktiengesetz*, secondly where the supervisory board has declared that objections which were raised against the report of the board of directors in respect of the relations between the subsidiary company and the holding company or related companies of the holding company be disregarded or thirdly where the board of

¹⁴⁸ S 312(1) and (3).

¹⁴⁹ *Lagebericht* according to s 312(3).

¹⁵⁰ In terms of s 30 read with ss 96-116 of the *Aktiengesetz* every company falling under the Act has a supervisory board which appoints and supervises the board of directors. The *GmbH* is not required to have a supervisory board but in terms of s 52 of the *GmbH Gesetz* it may have one.

¹⁵¹ S 313 read with s 314. Emmerich & Habersack *Konzernrecht* 558-570.

¹⁵² The report in terms of section 312.

¹⁵³ S 314(1) to 314(3). See also Kropff in Kropff & Semler *Münchener Kommentar* 941-942.

¹⁵⁴ S 314(4).

directors declared that the subsidiary company had been harmed by certain activities or measures and that the harm had not been remedied.¹⁵⁵

The *Aktiengesetz* contains additional measures intended to provide protection for minority shareholders. The *Aktiengesetz* provides that where a holding company issues directives to its dependent subsidiary company to engage in harmful business activities or to take detrimental business decisions without remedying the harm during or at the end of the financial year, the holding company has to pay damages to the subsidiary company. The holding company also has to pay damages to the minority shareholders of the subsidiary company if they suffered damages over and above the loss they suffered because of the harm caused to the subsidiary company.¹⁵⁶ The holding company is, however, relieved of this duty to make good any damages to the subsidiary company if a reasonable and diligent¹⁵⁷ business manager of an independent company would have undertaken the same business or issued the same business decisions.¹⁵⁸

The statutory agents are also jointly liable with the holding company for the envisaged damages.¹⁵⁹ The board of directors can also be held liable, over and above the liability envisaged in section 317 of the *Aktiengesetz*, for the failure of the holding company to remedy the detrimental directives which it issued to the subsidiary company by the end of the financial year. Like the holding company, the board of directors has a defence in the form of the reasonable and diligent business manager defence.¹⁶⁰ This means that if a reasonable and diligent business manager would have acted in the same way there will be no liability. The burden of proof is on the board of directors to show that they acted as reasonable and diligent business managers.¹⁶¹ The supervisory board of directors is also liable if it fails to consider the report of the auditor in respect of the detrimental business

¹⁵⁵ S 315 provides further that the shareholder or shareholders who bring the application must hold at least 5% of the issued share capital.

¹⁵⁶ S 317(1). See Emmerich & Habersack *Konzernrecht* 587-594.

¹⁵⁷ *Ordentlicher und gewissenhafter*.

¹⁵⁸ S 317(2).

¹⁵⁹ S 317(3). According to Emmerich & Habersack *Konzernrecht* 594 the statutory agent is the agent of the holding company who is responsible for the management of a company, usually the board of directors.

¹⁶⁰ S 317(2).

¹⁶¹ S 318(1).

relations between the holding company and the subsidiary company and fails to report the conclusions of the auditor's report to the shareholders meeting.¹⁶²

4.4.2.4 The integration of wholly owned subsidiary companies

The last group of provisions in the *Aktiengesetz* on enterprises deals with the integration of a wholly-owned subsidiary into the holding company and the consequences for shareholders and creditors of the subsidiary company.¹⁶³ Naturally the holding company as sole shareholder will decide whether it wants to integrate the wholly owned subsidiary company into the holding company, which has to be a domestic German company.¹⁶⁴ The shareholders of the holding company, by means of a 75% majority,¹⁶⁵ also have to approve the integration of the two companies.¹⁶⁶ Certain other formalities also have to be complied with to enable shareholders to make an informed decision.¹⁶⁷

The *Aktiengesetz* also allows a company which owns at least ninety-five percent of the share capital¹⁶⁸ of another company to integrate that company into the holding company.¹⁶⁹ The same requirements which are required for the integration of wholly owned subsidiary companies apply *mutatis mutandis*.¹⁷⁰

The legislature made provision for the remaining minority shareholders who hold up to 5% of the share capital of the subsidiary company. The shares of the minority vest in the holding company once the integration of the subsidiary company into the holding

¹⁶² S 318(2) read with s 314.

¹⁶³ S 319 – 327 of the *Aktiengesetz*.

¹⁶⁴ S 319(1). According to Grunewald in Kropff & Semler *Münchener Kommentar* 1025-1026 this integration does not constitute a merger since both companies still maintain their separate juristic personalities. The holding company is, however, entitled to use the assets of the wholly owned company.

¹⁶⁵ 75% of the issued share capital according to s319(2).

¹⁶⁶ S 319(2).

¹⁶⁷ These formalities include the provision of annual financial statements of the respective companies for the past three financial years and a report from the board of directors in which the board has to justify legally and economically the integration in terms of section 319(3). Section 319(4)–(7) set further formalities which need to be complied with, for example the registration of the integration in the commercial register, which is the effective date for the integration.

¹⁶⁸ *Grundkapital*.

¹⁶⁹ S 320(1).

¹⁷⁰ S 320(1) provides that section 319(1), second sentence and s 319(2) – s 319(7) will apply over and above the other requirements of s 320.

company is completed by means of registration in the commercial register.¹⁷¹ The minority shareholders are entitled to compensation for the (involuntary) loss of their shares. They become entitled to shares in the holding company as a *quid pro quo* for their shares.¹⁷² Should the holding company be a dependent company, i.e. a subsidiary company of another holding company, the minority shareholders have an election between receiving shares in that (subsidiary) company or to receive adequate compensation in cash for their shares.¹⁷³ The minority shareholders are not entitled to have the decision to integrate the holding company and the subsidiary company rescinded should the compensation for the loss of their shares be inadequate. Instead they are entitled to approach the court to determine what adequate compensation would be for their shares in the integrated company.¹⁷⁴ The holding company has to convene a shareholders' meeting of the subsidiary company to decide on the integration of the subsidiary into the holding company. The agenda has to include a declaration (offer) by the holding company to the minority shareholders to provide them with shares in the holding company, or where the holding company is itself a subsidiary, shares in the company and an offer of cash as an alternative.¹⁷⁵ The integration is also subject to further requirements.¹⁷⁶

Provision is also made to protect creditors of the integrated subsidiary company.¹⁷⁷ Security for the payment of proven claims has to be provided by the integrated (holding) company in so far as the claims of the creditors of the subsidiary cannot be satisfied.¹⁷⁸ The holding company becomes jointly liable for the obligations of the subsidiary which came into existence prior to the integration of the two companies, as well as for the obligations of the subsidiary which are proven or due after the date of the integration of

¹⁷¹ S 320a.

¹⁷² S 320b(1).

¹⁷³ S 320b(1). To determine what adequate compensation in the form of shares in the (subsidiary) company will be see the rest of s 320b(1).

¹⁷⁴ S 320b(2).

¹⁷⁵ S 320(2).

¹⁷⁶ S 320(3) provides that the integration has to be investigated by an (integration) auditor who is appointed by the (future) main (integrated) company. For the other requirements see s 320(4).

¹⁷⁷ S 321.

¹⁷⁸ S 321(1) read with s 322.

the two companies.¹⁷⁹ The holding company and subsidiary cannot enter into an enforceable contract with a third party unless the holding company also assumes liability for the obligations towards the third party.¹⁸⁰ The holding company has all the defences which the subsidiary would have had against the creditors of the subsidiary.¹⁸¹ The holding company can also refuse to satisfy a claim of a creditor of the subsidiary company for as long as the subsidiary has the right to attempt to have the underlying *causa* for the obligation rescinded.¹⁸² It can also refuse to satisfy a claim of a creditor of the subsidiary company should set-off between the claims of the subsidiary company and that creditor of the subsidiary company be possible.¹⁸³

The holding company becomes entitled to issue directives to the company which is integrated into the holding company.¹⁸⁴ The holding company is also entitled to enter into a written profit transfer agreement with the subsidiary company which is to be integrated without the need to meet the other requirements of the *Aktiengesetz* in such a case.¹⁸⁵

The shareholders of the holding company are also provided for. They are entitled to the same information in respect of the integrated company as they are concerning the holding company.¹⁸⁶ This means that the shareholders of the holding company are being treated as if they are shareholders of the integrated company.¹⁸⁷

The integration of the subsidiary company can also be terminated.¹⁸⁸ The integration of the subsidiary company is terminated if the shareholders of the integrated company

¹⁷⁹ S 322(1).

¹⁸⁰ S 322(1), third sentence.

¹⁸¹ S 322(2).

¹⁸² S 322(3), first sentence.

¹⁸³ S 322(3), second sentence.

¹⁸⁴ See s 323(3) which provides that s 308(2), first sentence, s 308(3), s 309 and s 310 will apply *mutatis mutandis*. S 323(3) also provides that the sections dealing with *de facto* groups, namely ss 311 to 318 will not apply to integrated companies. See para 4.4.2.3 above.

¹⁸⁵ See s 324(2) which provides that ss 293-296 and 298- 303, discussed in para 4.4.2.2.3, are not applicable in the case of integrated companies.

¹⁸⁶ S 326.

¹⁸⁷ Emmerich & Habersack *Konzernrecht* 697.

¹⁸⁸ S 327.

decide to terminate the integration,¹⁸⁹ if the holding company ceases to be a stock company with its main office in Germany,¹⁹⁰ if the holding company ceases to own all the shares in the integrated company¹⁹¹ or if the holding company is dissolved.¹⁹² If the holding company no longer owns all the shares of the integrated company, it has to inform the integrated company in writing.¹⁹³ The board of directors of the hitherto integrated company has to notify the relevant authority about the termination of the integration of the companies, the basis for the termination as well as the time of the termination. The relevant authority will then register this termination in the commercial register.¹⁹⁴ All claims of creditors against the hitherto main company prescribe after five years from the date on which the registration of the termination of the integration became effective unless a shorter period of prescription applies. Prescription only starts to run from the date on which a debt becomes due and payable, if the debt becomes due and payable after the date on which the registration of the termination of the integration took effect.¹⁹⁵ The legislature therefore provides for the position of creditors in the case of termination of the integration.

4.4.2.5 Squeeze out of minority shareholders

The last relevant group of provisions is contained in only one section with various subsections. This section deals with the position of minority shareholders in cases where the integration of the subsidiary company is not contemplated.¹⁹⁶ Emmerich and Habersack describe this situation as a “squeeze out”.¹⁹⁷ Once a company owns ninety-five percent of the issued share capital of another company, the former company may acquire the remaining shares for adequate cash payment.¹⁹⁸ The rest of the applicable section regulates the cash payment or offer which is to be made to the minority

¹⁸⁹ S 327(1)1.

¹⁹⁰ S 327(1)2.

¹⁹¹ S 327(1)3.

¹⁹² S 327(1)4.

¹⁹³ S 327(2).

¹⁹⁴ S 327(3).

¹⁹⁵ S 327(4).

¹⁹⁶ S 327.

¹⁹⁷ Emmerich & Habersack *Konzernrecht* 705.

¹⁹⁸ S 327a(1).

shareholders,¹⁹⁹ the formalities for the shareholders meeting of the company in which the majority company owns at least ninety-five percent,²⁰⁰ the registration of the decision to expropriate the shares of the minority in the commercial register²⁰¹ and the fact that the minority shareholders may not apply for the rescission of the expropriation if they are of the opinion that the compensation for their shares is not adequate. Instead they may apply to court to determine what the adequate cash payment should be.²⁰² The provisions regarding the determination of the cash payment largely correspond to those when integration of the subsidiary company takes place.²⁰³

4.5 Evaluation of the German Enterprise law

4.5.1 General comments on the provisions of the *Aktiengesetz*

Prima facie the German enterprise law appears to be the perfect system. The third book of the *Aktiengesetz* provides for controlling and dependent companies to enter into agreements in terms of which the controlling company may issue directives to the subordinate company and therefore manage the subordinate company, even to the detriment of that company. Creditors are, however, protected as are the minority shareholders. Provision is also made for the integration of a subsidiary into the operations of the holding company where the holding company has an overwhelming majority of the shares in the subsidiary, namely ninety-five percent. In this situation creditors and minority shareholders are also protected.

The third book of the *Aktiengesetz* also provides for *de facto* enterprises where one company holds the majority shares in another company. Provision is then made for the manner in which the holding company could be held liable for any detrimental instructions which it issued to the subsidiary company. The question is whether the German system is a system which South Africa could adopt. Interestingly Brazil, a

¹⁹⁹ S 327b.

²⁰⁰ S 327c and d.

²⁰¹ S 327e.

²⁰² S 327f.

²⁰³ See para 4.4.2.4 above.

developing nation like South Africa, adopted a system similar to that of Germany regarding enterprise law.²⁰⁴

As a point of departure it appears that the contractual group option²⁰⁵ is not popular in Germany.²⁰⁶ The reasons for the lack of interest in the contractual group option are probably the lack of any incentives for the dominant company and the fact that it becomes liable for the debts of the subordinate company. The obvious alternative is therefore the *de facto* group option, despite the fact that the *Aktiengesetz* places a heavier burden on the holding company due to the control which it exercises over the subordinated company.

Antunes points out a number of difficulties with the German enterprise provisions. In respect of contractual groups, he points out that the contract is one where one party, the dominant company, decides unilaterally on the question whether the domination contract should be concluded, the date of the contract and its terms. The dominant company can decide and thus manipulate the date on which to terminate the contract to benefit it and to the detriment of the minority shareholders of the subordinate company.²⁰⁷

Antunes refers to the system which regulates *de facto* groups as a theoretical fallacy.²⁰⁸ He regards it as a theoretical fallacy in the light of the fact that the German legislature attempted to reach a compromise between two positions, namely the fact that the holding company enjoys the power to dominate the subsidiary due to its shareholding and the principle that each juristic person is a separate entity, so that the subsidiary company is in theory free to determine its own future.²⁰⁹ Antunes finds this to be an inherent attempt to reconcile the irreconcilable.

²⁰⁴ See ch XXI of the Brazilian Corporations Law of 1976. See, for example s 256 of the Act where provision is made for a domination agreement. Mauricio Teixeira dos Santos, an eminent Brazilian corporate lawyer, mentions in an e-mail of 10 March 2010 that domination agreements are not common in Brazil.

²⁰⁵ Para 4.4.2.2 above.

²⁰⁶ Emmerich & Habersack *Konzernrecht* 110 n 541. Antunes *Liability of Corporate Groups: Autonomy and Control in Parent-Subsidiary Relationships in US, German and EU Law, An International and Comparative Perspective* (1994) 331.

²⁰⁷ Antunes *Liability of Corporate Groups* 333.

²⁰⁸ Antunes *Liability of Corporate Groups* 347.

²⁰⁹ Antunes *Liability of Corporate Groups* 347.

An investigation of the provisions which regulate *de facto* groups reveals three statutory mechanisms to protect the subsidiary company and therefore indirectly its minority shareholders and creditors. These mechanisms are firstly, the obligation of the holding company to indemnify or compensate the subsidiary company for every detrimental legal transaction or for every detrimental measure or business decision which the holding company directed the subsidiary company to take. This indemnity or compensation has to be paid immediately or at the end of the financial year.²¹⁰ The second protective mechanism is the requirement of the dependency report by the board of the subsidiary as well as its verification by an independent third party, an auditor.²¹¹ The third protective measure is the liability of the holding company to indemnify or compensate the subsidiary company under the envisaged circumstances.²¹² Problematic is, however, any direct liability *vis-à-vis* the creditors of the subsidiary company. The provisions of the *Aktiengesetz* only protect the subsidiary company and its minority shareholders. If the subsidiary company is a *GmbH* the creditors may attempt to pierce the corporate veil to hold the shareholders liable and this attempt to hold the holding company liable is available in the qualified factual enterprise situations.²¹³

The mechanisms to protect the subsidiary company against detrimental business transactions and decisions need to be briefly evaluated to determine whether they provide adequate protection. Kropff highlights a number of problems with the relevant provisions. In the first place it may be difficult to distinguish whether a specific business decision or transaction stemmed from a directive of the holding company or whether the decision was made by the board of directors of the subsidiary company.²¹⁴ The nature of a group of companies is such that some of the directors will often serve simultaneously on the boards of several companies within the group. Even if there are no directors in common on the boards of the holding company and the subsidiary company, it could still be difficult to determine whether the subsidiary acted at the behest of the holding

²¹⁰ See s 311 above.

²¹¹ Ss 312 and 313.

²¹² S 317.

²¹³ Assmann, Lange & Sethe *Business Corporations* 168 and see para 4.5.2 below.

²¹⁴ Kropff *Münchener Kommentar* 772.

company. It is easily conceivable that the subsidiary company may, on its own initiative, engage in activities to promote the interests of the group independently, despite the detriment to itself. The nature of a group of companies is furthermore such that cooperation between the various companies is inevitable in respect of planning, production, information technology and the like.²¹⁵ Furthermore the information to determine whether a harmful business decision was due to the directives of the holding company falls within the knowledge of the management of the holding company and the subsidiary company. It may be difficult for the minority to provide the requisite proof that the subsidiary company acted at the behest of the holding company.²¹⁶

The second problem according to Kropff is the determination of what qualifies as a detrimental transaction or decision.²¹⁷ The German legislature addresses this question by providing that one should ask whether a reasonable and diligent²¹⁸ business manager of an independent company would have undertaken the same business transaction or made the same business decision under the circumstances.²¹⁹ This provision appears to be similar to the business judgement rule which has been adopted in the new South African Companies Act. The new Companies Act provides that

“(3) Subject to subsections (4) and (5), a director of a company, when acting in that capacity, must exercise the powers and perform the functions of director—
 (a) in good faith and for a proper purpose;
 (b) in the best interests of the company; and
 (c) with the degree of care, skill and diligence that may reasonably be expected of a person—
 (i) carrying out the same functions in relation to the company as those carried out by that director; and
 (ii) having the general knowledge, skill and experience of that director.
 (4) In respect of any particular matter arising in the exercise of the powers or the performance of the functions of director, a particular director of a company—
 (a) will have satisfied the obligations of subsection (3)(b) and (c) if—
 (i) the director has taken reasonably diligent steps to become informed about the matter”²²⁰

The point of comparison is the objective component of the business judgement test (reasonableness) and the requirement of skill. The tenor of this provision of the new

²¹⁵ Kropff *Münchener Kommentar* 772.

²¹⁶ Antunes *Liability of Corporate Groups* 348.

²¹⁷ Kropff *Münchener Kommentar* 772.

²¹⁸ “ordentlicher und gewissenhafter”

²¹⁹ S 317(2) of the *Aktiengesetz*.

²²⁰ S 76(3)-(4)(a)(i).

Companies Act is clear. If a director acted reasonably, namely with the necessary care and skill, no liability will accrue to that director for decisions which were taken and which were ultimately harmful to the company.

The first problematic aspect of the German test for a detrimental transaction is that although the subsidiary company is *de iure* an independent entity, *de facto* it is under the control of the holding company. It is therefore difficult to compare the decisions of the subsidiary company with the decisions of an independent company.

The second problematic aspect is that one is working here with the fictional notion of the management of an independent company. This means that one has to determine *ex post facto* whether the management of an independent company would have acted in the same way in the given circumstances. Antunes avers that, in the light of the unpredictable nature of the business environment and the relevant market, whether internal or external, and the broad discretion which management has in respect of the management of a company (the business judgement rule), the determination of the conduct of the management of a notional independent company is very difficult. He argues that the standard which has been set will only be of value in circumstances of “exceptional cases of notorious or scandalous subsidiary mismanagement”.²²¹

The question can also be asked whether there must be damages for the protective measures to become operative. The logical answer would probably be that the holding company would only have to indemnify the subsidiary company should the latter suffer loss due to the directives of the holding company. Kropff argues that there can be harm or detriment without damages being suffered. He provides the example of a subsidiary company which engages in a risky venture which necessitates a higher *quid pro quo*. Even if there is an eventual advantage to the subsidiary company it was a detrimental transaction when it was entered into. If the subsidiary company acted at the behest of the holding company the provisions of the *Aktiengesetz* would become operative.²²²

²²¹ Antunes *Liability of Corporate Groups* 351.

²²² Kropff *Münchener Kommentar* 827 and see also Antunes *Liability of Corporate Groups* 352.

The next problem which Antunes identifies is the problem of quantifying the harm which the subsidiary company suffered due to the directives of the holding company. The first issue again concerns how the management of an independent company would have acted in those circumstances? Would they have entered into the transaction? If so, would it have been on the same terms, with the same contracting party and at the same price?²²³ What if the answer to some of the questions is “yes” and “no” to others? Is there still liability? Can a person determine a causal link between the specific offending term which the management of an independent company would not have accepted and the eventual harm that was suffered? The quantification of damages could in some circumstances be easy but in other cases very difficult. In a situation like the one under discussion the added problem lies in determining whether the management of an independent company would have acted differently. Once that complex question is determined, the extent of the loss has to be proved which can make the whole exercise very complicated and difficult for minority shareholders or creditors of the subsidiary company, with the added complication of a lack of information.

Another relevant consideration is the need to determine what the interests of the subsidiary company are. Does the subsidiary company exist solely for its own benefit or for the benefit of the group, especially in those cases where the group constitutes one economic unit? On the assumption that the subsidiary company is merely one part of the bigger picture, how does one attempt to quantify harm for the subsidiary where the group has benefited and that benefit has directly or indirectly benefited the subsidiary company?²²⁴

4.5.2 The regulation of qualified factual groups²²⁵

One of the major shortcomings which has been identified in the German enterprise law is the regulation of qualified factual groups. Whereas the *Aktiengesetz* makes provision for contractual enterprises and *de facto* enterprises, it is silent on qualified factual groups. A

²²³ Antunes *Liability of Corporate Groups* 353.

²²⁴ Antunes *Liability of Corporate Groups* 360.

²²⁵ *Qualifizierte faktische Konzerne*.

qualified factual group is generally speaking one where the holding company²²⁶ is permanently responsible for the management of the subsidiary company and therefore exercises permanent control over the day to day management of the subsidiary company.²²⁷ The qualified factual group differs from both options envisaged by the *Aktiengesetz*. The difference is that there is neither a contract between the holding company and the subsidiary company nor is there *ad hoc* interference by the holding company as envisaged by the applicable provisions of the *Aktiengesetz*.²²⁸ The liability of the holding company as envisaged by the *Aktiengesetz* is therefore restricted to liability determined on a case by case basis for a detrimental business transaction or decision which is capable of being remedied by an indemnity by the holding company.²²⁹ Since qualified factual groups have no statutory basis it has been left to the judiciary to determine firstly what the definition of a qualified factual group is and secondly what, if any, liability ensues from its (permanent) management of the subsidiary company and when such liability will ensue.

The first important decision in respect of qualified factual groups was the *Autokran*²³⁰ decision. The court recognised that the protective mechanisms of the *Aktiengesetz* in respect of *de facto* groups do not apply to a qualified factual group.²³¹ The court recognised the difficulty in determining when a qualified factual group can be said to exist. The court looked at *indiciae* of a qualified factual group. It firstly referred to the fact that the controlling party exercised control over the subsidiaries as if they were divisions of the business.²³² It referred secondly to the fact that the controlling party *in*

²²⁶ It can also be a natural person who exercises the control and management.

²²⁷ Schmidt *Gesellschaftsrecht* 3ed (1997) 1220; Antunes *Liability of Corporate Groups* 368; Emmerich & Habersack *Konzernrecht* 599-614 with reference to Hueck, Lutter, Mertens, Rehbinder, Ulmer, Wiedemann & Zöllner *Thesen und Vorschläge zur GmbH-Reform* (1972) 2 49.

²²⁸ Emmerich & Habersack *Konzernrecht* 599. See also para 4.4.2.3.

²²⁹ Kropff *Münchener Kommentar* 987 “Das Schutzsystem der §§311ff geht von einer im Einzelfall feststellbaren und ausgleichsfähigen nachteiligen Veranlassung aus, die bei Nichtausgleich für einen ebenso feststellbaren Schaden der abhängigen Gesellschaft ursächlich ist.”

²³⁰ *Autokran* BGH 2nd Zivilsenat 95, 330, decided on 16 September 1985, *ZIP* (1985) 1263 and also *NJW* (1986) 188.

²³¹ Paragraph 4 of the decision and see also paragraph 27(5b).

²³² Paragraph 24(5a).

casu had extensive and continuous control over the dependent companies.²³³ The court concluded that the provisions of the *Aktiengesetz*, which protect creditors where a domination agreement exists between two parties, could be applied to a case such as the present.²³⁴

The next important decision was the *Tiefbau*²³⁵ decision. In this case the facts showed that there was neither a domination agreement nor a *de facto* group situation as envisaged by the *Aktiengesetz*. The claimant therefore attempted to hold the controlling shareholders liable on the basis of section 302 of the *Aktiengesetz*, namely the provision in terms of which the controlling entity in terms of a domination agreement incurs liability for the losses of the subordinate company. The court recognised that no conclusive test has been established to determine when sections 302 and 303 of the *Aktiengesetz* will apply in respect of the German *GmbH* enterprise.²³⁶ The court held that where the controlling shareholders were responsible for the financial management of the dependent company and their management caused the losses, they will incur liability in terms of the *Aktiengesetz*.²³⁷ The controlling shareholders can escape liability by showing that they were not permanently in control of the dependent company and even if they were, that this did not cause the loss.

The next case was the *Video*²³⁸ case. In this case the court held that the fact that a company only had one shareholder was sufficient to show a continuous and extensive management by the controlling shareholder.²³⁹ Subsequent to the *Video* case in the *TBB*²⁴⁰ case the court apparently changed direction by not focusing on the permanent and extensive control which the controlling shareholder exercised over the dependent company. Instead it held that one has to investigate whether the controlling shareholder, objectively speaking, abused his management power. Such abuse would be present when

²³³ Paragraph 28(5b). In the original German the court held that “der Beklagte...die Geschäftsführung der Leasingnehmer-Gesellschaften *dauernd und umfassend* ausgeübt hat.” [my italics]

²³⁴ Paragraph 30(5c).

²³⁵ *Tiefbau* BGH 2nd Zivilsenat, decided on 20 February 1989. See *NJW* (1989) 1800.

²³⁶ Paragraph 25(3).

²³⁷ Paragraph 30.

²³⁸ *Video* BGH 2nd Zivilsenat, decided on 23 September 1991, 115, 187. See also *NJW* (1991) 3142.

²³⁹ Paragraph 14(2aa).

²⁴⁰ *TBB* BGH 2nd Zivilsenat, decided on 23 March 1993, 122, 123. See also *NJW* (1993) 1200.

the controlling shareholder manages the dependent company in a manner that does not take into consideration the separate interests of the dependent company and without compensating any disadvantages which may follow.²⁴¹

In the *Bremer Vulkan*²⁴² decision the court looked at whether the controlling shareholder endangered the continued existence of the dependent (subsidiary) company. In this case the court also held that

“liability for the sole shareholder of a dependent *GmbH* does not accrue in terms of the *Aktiengesetz* but in terms of the relevant provisions of the *GmbH* Act. The sole shareholder has to take the position of the company into consideration when he withdraws assets from the company. The sole shareholder has not taken due care if the company cannot meet its obligations due to the withdrawal of assets by the sole shareholder.”²⁴³

Altmeppen²⁴⁴ was of the opinion after the *Bremer Vulkan* case that the doctrine of the qualified factual enterprise came to an end in the light of the abovementioned quotation. It would appear that the court held that the creditor should find his remedy in the *GmbH* statute. Schmidt, however, maintains that the doctrine still existed despite the *Bremer Vulkan* decision.²⁴⁵

The most recent decision which could be found on this topic was the *Trihotel*²⁴⁶ decision of the Bundesgerichtshof. The court stated the following:

“Instead liability accrues in terms of section 826 of the German Civil Code as one of the unique forms of *contra bonos mores* acts causing damages. The claim for damages in terms of the German Civil Code is ancillary to the causes of action in terms of sections 30 and 31 of the *GmbH*

²⁴¹ Paragraph 28(bb).

²⁴² *Bremer Vulkan* BGH 2nd Zivilsenat, 149, 110 and decided on 17 September 2001. See also NJW (2001) 3622.

²⁴³ Paragraph 11. “*Der Schutz einer abhängigen GmbH gegenüber Eingriffen ihres Alleingeschafters folgt nicht dem Haftungssystem des Konzernrechtes des Aktiengesetzes (§§ 291 ff. AktG). Er beschränkt sich auf die Erhaltung ihres Stammkapitals im Sinne der §§ 30 f. GmbHG, für die im Rahmen des § 43 Abs. 3 GmbHG auch ihre Geschäftsführer haften, und die Gewährleistung ihres Bestandsschutzes in dem Sinne, daß ihr Alleingeschafters bei Eingriffen in ihr Vermögen und ihre Geschäftschancen angemessene Rücksicht auf ihre seiner Disposition entzogenen eigenen Belange zu nehmen hat.*”

²⁴⁴ Altmeppen “Gesellschafterhaftung und Konzernhaftung bei der GmbH” NJW (2002) 5 321

²⁴⁵ Schmidt NJW (2001) 3577.

²⁴⁶ *Trihotel* BGH 2nd Zivilsenat, 173, 246 and decided on 16 July 2007. See also NJW (2007) 2689.

Act. Section 826 of the German Civil Code essentially provides that a person who causes another person harm due to his *contra bonos mores* actions will be liable for the loss of that person.”²⁴⁷

Altmeppen²⁴⁸ argues that the *Trihotel* decision is a departure from the doctrine of piercing the corporate veil in *Kapitalgesellschaften*. Instead it would appear that the German judiciary imposed liability on delictual grounds as provided for in the German Civil Code read with the *GmbH* Act.

4.6 Conclusion

An analysis of the German enterprise law shows that the German system is not as effective as one may at first think. The first reason for this is the fact that the application of the provisions in the *Aktiengesetz*, which deal with enterprise law, is restricted to those cases where an *Aktiengesellschaft* or a public limited partnership by shares²⁴⁹ is the dependent company.²⁵⁰ It can be safely assumed that for small and medium (family) enterprises the preferred method for conducting business would be either by means of a partnership or by using the *GmbH*.²⁵¹ This is evidenced by the development of case law regarding the qualified factual enterprise doctrine. The continued existence of this doctrine seems to be in doubt in light of the *Bremer Vulkan* and *Trihotel* decisions discussed above.

A further problem with the German system is the inadequacy of the provisions dealing with remedies for *ad hoc* interference in the management of a dependent subsidiary by the holding company in the light of the fact that a creditor of the dependent company will first have to show that the holding company or controlling shareholder issued detrimental

²⁴⁷ Paragraphs 38 – 40. “Stattdessen knüpft er die Existenzvernichtungshaftung des Gesellschafters an die missbräuchliche Schädigung des im Gläubigerinteresse zweckgebundenen Gesellschaftsvermögens an und ordnet sie - in Gestalt einer schadensersatzrechtlichen Innenhaftung gegenüber der Gesellschaft - allein in § 826 BGB als eine besondere Fallgruppe der sittenwidrigen vorsätzlichen Schädigung ein. Schadensersatzansprüche aus Existenzvernichtungshaftung gemäß § 826 BGB sind gegenüber Erstattungsansprüchen aus §§ 31, 30 GmbHG nicht subsidiär; vielmehr besteht zwischen ihnen - soweit sie sich überschneiden – Anspruchsgrundlagenkonkurrenz.” In essence therefore this is a form of delictual liability. In this respect see chapter 7 para 7.9 regarding Dutch Law.

²⁴⁸ Altmeppen “Abschied vom “Durchgriff” in Kapitalgesellschaftrecht” *NJW* (2007) 37 2657.

²⁴⁹ Kapitalgesellschaft auf aktien.

²⁵⁰ Assmann in Sugarman & Teubner (ed) *Regulating Corporate Groups in Europe* (1990) 329.

²⁵¹ According to Assmann, Lange & Sethe *Business Corporations* 143 in 2000 there were over a million GmbHs, 100 public limited companies and between 10 000 and 11 000 stock corporations in Germany in 2000.

business instructions to the dependent company or forced it to make disadvantageous business decisions, which caused harm to the dependent company. Once this has been established the holding company or controlling shareholder can still escape liability by means of the business judgment rule. Even if these two hurdles are overcome the quantification of the loss or detriment could still be difficult.

The principle or rationale underlying enterprise law system in Germany is, however, sound as the reality of an enterprise is accepted as the point of departure. It goes wrong in the application of the principle, however. There is no apparent advantage of the domination agreement except tax benefits.²⁵² Once there is no real advantage in a system, it in effect becomes obsolete through its non-use. This seems to have been the case in respect of domination agreement.

As the domination agreement model has not been successful it has to be established whether the *de facto* enterprise system could be of any value for the development of the South African law. It appears, however, that South African company law already provides some similar, if not all, the answers as the German *de facto* enterprise system. The new Companies Act provides that the directors of a company may not act to the detriment of its subsidiary company.²⁵³ Furthermore in *Barlows Manufacturing Co Ltd v RN Barrie (Pty) Ltd*²⁵⁴ the court held that although a director may delegate his powers of control he may never abdicate those powers because this would breach his fiduciary duty. This means that the board of directors of the subsidiary company may consult their holding company but may never abdicate their duties to the (board of directors) of the holding company. This could be interpreted as being similar to the German provisions which determine that where the holding company issues detrimental business instructions to the subsidiary company, any losses which are suffered by the dependent subsidiary company have to be indemnified by the holding company.²⁵⁵

²⁵² Antunes *Liability of Corporate Groups* 331.

²⁵³ Section 76(2)(a)(ii).

²⁵⁴ *Barlows Manufacturing Co Ltd v RN Barrie (Pty) Ltd* 1990 4 SA 608 (C) 610I-J.

²⁵⁵ Para 4.4.2.3 above.

The new Companies Act makes provision for the business judgment rule²⁵⁶ which may provide a defence for the directors of the subsidiary company where it is alleged that they breached their fiduciary duties toward the subsidiary company. A creditor of the subsidiary, who fails with his claim against the directors of the subsidiary company, will then be obliged to proceed against the holding company or its directors. The creditor will have to prove that their actions caused harm to the subsidiary, making it very difficult for the creditor to discharge the burden of proof.²⁵⁷

The German *de facto* enterprise system should also be understood in its historical context. The 1937 *Aktiengesetz* did not contain a similar regulatory regime like the provisions of the *Aktiengesetz* which regulates *de facto* enterprises.²⁵⁸ The initial draft of the 1965 Stock Corporations Act clung to the independent existence of the subsidiary company and its autonomy. The holding company could not issue business directives to the subsidiary company and interfere in its management. Were it to do so it would incur liability, jointly with the management of the holding company, for the damages which resulted from those directives or decisions.²⁵⁹ According to Kropff this suggested system was fraught with difficulties, was draconian and could have unintended consequences.²⁶⁰ According to Kropff there were also problems related to the enforcement of the provisions and the provisions were deemed to be *Haifisch ohne Zähne*²⁶¹ by some commentators.²⁶²

According to Antunes, Flume, a celebrated German jurist, made proposals to amend the initial version. Flume proposed that any harm had to be remedied with any benefit that flowed from a disadvantageous business directive by the holding company. An obligatory

²⁵⁶ Section 76(4)–(5) read with section 76(3).

²⁵⁷ See chapter 5 below for a discussion of the South African Company Law as well as para 4.5.1 above.

²⁵⁸ Kropff *Münchener Kommentar* 768.

²⁵⁹ Kropff *Münchener Kommentar* 769 with reference to s 284 of the “*Referentenentwurf eines Aktiengesetzes*” as published by the Federal German Ministry of Justice in 1958.

²⁶⁰ Kropff *Münchener Kommentar* 769 “*Die reformdiskussion erwies diesen Weg als nicht gangbar. Einerseits erschien die Erfolgshaftung drakonisch scharf, weil sie auch bei wohlgemeinten, aber unvorhersehbar fehlgeschlagenen Maßnahmen des Großaktionärs eingriff.*” The reform discussions showed that this way was not viable. It appeared that the liability would be draconian because there would also be liability if there is loss although the majority shareholder took well-meaning but unforeseeably failed measures.

²⁶¹ A shark without teeth.

²⁶² Kropff *Münchener Kommentar* 769.

report had to be submitted which provided the details of all the holding company and subsidiary company relations.²⁶³ This proposal was more acceptable than the initial draft but there was also criticism.²⁶⁴ The enacted version heeded the criticism and provides that the harm can be remedied throughout the financial year and the harm does not have to be remedied from any benefit which flowed from the detrimental business directive or decision.²⁶⁵

The issue of qualified factual groups has apparently now been dealt with by the German judiciary. Even if there is still no clarity it is my submission that such an issue would not be as problematic in a common-law jurisdiction. By limiting the application of the provisions dealing with enterprise law to only some companies, the German legislature invited uncertainty and left it for the courts to develop rules for those circumstances where the *Aktiengesetz* was not applicable. The courts then merely adopted the same rules as the provisions of the *Aktiengesetz* to cater for the situations where companies were involved in an enterprise, but which were not covered by the *Aktiengesetz*. The (permanent) interference in the management of a company could however be a vital ground for a court to hold a holding company liable in a common-law jurisdiction.²⁶⁶ Practically speaking therefore, the German statutory system has not achieved much but it would appear that it has been the judiciary, influenced by academic scholars, which has taken the initiative to develop the German enterprise law system.

The most important problem, which the provisions of the *Aktiengesetz* regarding factual groups have not directly addressed, is the direct liability of the holding company towards the creditors of the subsidiary company. Instead the protection is afforded to the subsidiary company by means of the provisions to the effect that any detrimental measures undertaken by the subsidiary company at the behest of the holding company have to be made good by the holding company. A creditor will therefore be restricted to

²⁶³ Antunes *Liability of Corporate Groups* 343.

²⁶⁴ Antunes *Liability of Corporate Groups* 343 and Kropff *Münchener Kommentar* 770 who refers to Zahn who called the proposals stingy (*engherzig*) and also the fact that the proposal, by linking the harm and the benefit of the transaction, which had to remedy the harm, was too narrow.

²⁶⁵ Antunes *Liability of Corporate Groups* 344 and Kropff *Münchener Kommentar* 770.

²⁶⁶ See the *indiciae* in the New Zealand Act and those in the American jurisprudence in chapter 7 below.

the piercing of the corporate veil remedy to hold the holding company directly liable for the debts of the subsidiary company. This, it would appear, occurs where qualified factual groups are present. Alternatively, if the *Trihotel* decision has replaced the piercing of the corporate veil doctrine with a delictual remedy in terms of the German Civil Code, a creditor will have to base his claim on what the South African jurist would refer to as a delictual claim for pure economic loss.²⁶⁷ A claim based in delict differs from the traditional piercing of the corporate veil remedy which is contractual in nature. The arguments of the court in the *Trihotel* decision resemble the arguments of the Dutch courts in cases where the holding company had been held liable for the debts of the insolvent subsidiary.²⁶⁸

²⁶⁷ See chapter 7.2.3 below.

²⁶⁸ See chapter 7.6 below.

Chapter 5

The South African law on company groups

5.1 Introduction

The purpose of this chapter is to give an overview of the South African law relating to company groups. It also considers to what extent the South African law recognises the possible reality of groups as single entities, and to what extent the law still reflects the principle of limited liability where company groups are involved. Reference will be made to statutes on company law, competition law, tax law and consumer protection. The chapter will also investigate the statutory developments that influenced company groups as well as the evolution of the concepts of “holding company” and “subsidiary company”. In the process, the interpretation of certain aspects of these statutory provisions by the courts will be discussed. At the end of the chapter the judicial approach to groups in some of these fields will also be investigated. A discussion regarding the judicial approach to company groups in the fields of the law of delict and insolvency law will be left for later chapters.¹

5.2 Statutory definitions relating to company groups

The concepts of a holding company and a subsidiary were not initially part of the Companies Act 46 of 1926. A definition was only inserted at a later stage after the concept received attention by the English legislature.² The concept first received statutory attention in the English Companies Amendment Act of 1928 and the amendment was then incorporated in the 1929 Companies Act. In terms of the 1929 English Act,³ a company was seen as being a subsidiary of another company if the other company was a shareholder and that company, firstly, either had more than 50% of the issued share capital or had more than 50% of the voting power, or secondly, where that company could appoint the majority of the directors of the subordinate company. Membership of the subsidiary as such was clearly not a prerequisite, since the 1929 Act only refers to

¹ Chapters 6 and 7.

² Company Law Amendment Committee Cmnd 2657 of 1925/6.

³ S 127.

shareholding and not membership. Via an amendment⁴ the concepts of subsidiary and holding company were introduced into the South African Companies Act 46 of 1926 in 1939. “Holding company” was defined as follows:

“‘Holding company’ means a company whose assets consist in whole or in part of shares in another company, whether a company within the meaning of this Act or not, and whether such shares are held directly or through a nominee, and

- (1) which, at the time when its accounts are made up, so holds more than fifty per cent of the issued share capital of that other company, or is entitled to more than fifty per cent of the voting power in that other company; or
 - (2) which has power (not being power vested in it by virtue only of the provisions of a debenture trust deed or by virtue of shares issued to it for the purpose in pursuance of such provisions) directly or indirectly to appoint a majority to the directors of that other company;
- and 'subsidiary company' has a correlative meaning.”⁵

The 1939 Amendment Act in essence followed the wording of its English counterpart although a new concept, namely that of a subsidiary of a subsidiary, was also introduced.⁶ The English Companies Act was then amended in 1948 which resulted in the Companies Amendment Act 46 of 1952 in South Africa. The Act again followed the scheme of its 1948 English counterpart and a new definition of holding company and subsidiary company was introduced that replaced the definition contained in the 1939 Companies Amendment Act. This definition read as follows:

- “(1) For the purposes of this Act, a company shall ... be deemed to be a subsidiary of another only if -
- (a) that other either -
 - (i) is a member of it and controls the composition of its board of directors; or
 - (ii) holds more than half in nominal value of its equity share capital; or
 - (b) the first-mentioned company is a subsidiary of any company which is that other's subsidiary; provided that the first-mentioned company shall be deemed to be a subsidiary of that other if subsidiaries of that other between them hold more than one-half in

⁴ S 115 of the Companies Amendment Act 23 of 1939.

⁵ S 229 of the Companies Act 46 of 1926.

⁶ Blackman, Jooste & Everingham *Commentary on the Companies Act 1* (2002) Introduction-13.

- nominal value of the equity share capital of the first-mentioned company or if that other and one or more of its subsidiaries between them hold more than one-half of such capital.
- (2) For the purposes of ss (1), the composition of a company's board of directors shall be deemed to be controlled by another company only if that other company, by the exercise of some power exercisable by it without the consent or concurrence of any other person, can appoint or remove the holders of all or a majority of the directorships; but for the purpose of this provision that other company shall be deemed to have power to appoint to a directorship with respect to which any of the following conditions is satisfied, that is to say -
- (a) that a person cannot be appointed thereto without the exercise in his favour by that other company of such power as aforesaid; or
- (b) that a person's appointment thereto follows necessarily from his appointment as director of that company.”⁷

Membership was again not a requirement in all cases but only where the existence of the relationship depended on control of the board of directors. According to Coetzee J in *Unisec Group Ltd and Others v Sage Holdings Ltd*⁸ the 1952 Amendment Act expanded and tightened the control of the holding company / subsidiary company relationship. The 1926 Companies Act, as amended, also introduced provisions which were either aimed to provide sufficient disclosure of the financial position of a subsidiary in the annual financial statements of the holding company, or to prevent abuse.⁹

The next development was the overhaul of the companies legislation in 1973 with the introduction of the Companies Act 61 of 1973 (“the 1973 Act”). The 1973 Act was a result of the Van Wyk De Vries Commission which suggested that the various relationships between companies within the same group could not be accommodated under a single “controlling company/subsidiary company relationship”.¹⁰ The Commission identified certain forms of abuse that could take place in the holding company / subsidiary company structure and aimed to eradicate such abuse. The Commission recommended that the provisions which dealt with disclosure had to be separated from the provisions which dealt with the prevention of abuse by holding

⁷ S 90 nov of the Companies Act 46 of 1926.

⁸ *Unisec Group Ltd and Others v Sage Holdings Ltd* 1986 3 SA 259 (T).

⁹ De Wet & Van Wyk *De Wet en Yeats Kontraktereg en Handelsreg* 4ed (1978) 690.

¹⁰ De Wet & Van Wyk *Handelsreg* 690.

companies and subsidiaries. The provisions which dealt with disclosure focused on the relationship between the holding company and a subsidiary company, and this relationship was based on the shareholding which the holding company held in the subsidiary company. Control was therefore irrelevant.¹¹ The provisions which focused on the prevention of abuse, however, were based upon control, regardless of the shareholding of one company in another. According to De Wet and Van Wyk the above distinction was not tenable and was also not consistently applied by the Commission.¹² The legislature accepted the recommendations and made further amendments which led to more confusion.¹³ The result was by no means satisfactory.¹⁴ In fact, the attempt to address the issue in the Act was a total failure. As a result, the former definition of holding company-subsidary company, as reflected by the Companies Amendment Act 46 of 1952, was to a large degree restored in 1974. Membership was again made a requirement in situations where the definitions provided for control over the board of directors of the subsidiary company. In both the 1973 and 1952 versions shares that were held in a fiduciary capacity or through a nominee were to be treated as being held by the beneficial owner to determine the status of a company as a holding company. The outcome of the 1974 amendment was also not entirely satisfactory.¹⁵

The definition of the subsidiary-holding company concept again underwent surgery by means of the Companies Amendment Act 82 of 1992. Whereas the previous definition focused on control of the composition of the board coupled with membership of that company or alternatively, the holding of the majority of equity shares by a company

¹¹ De Wet & Van Wyk *Handelsreg* 690.

¹² De Wet & Van Wyk *Handelsreg* 690.

¹³ De Wet & Van Wyk *Handelsreg* 691.

¹⁴ See *Unisec* above 268-269 where the court states: "Regrettably, the Legislature, in its haste, did not heed criticisms of the 1952 definition which were voiced from time to time. [W]hether a company is a subsidiary of another or not is a question the answer to which carries a large number of important consequences and ... it seemed a pity that a more satisfactory definition could not be found. One glaring example ... is the strange prerequisite (introduced by the 1952 Act) of H Co's membership of S Co when control of the composition of the board of directors of S Co is the test. As there is no deeming provision in respect of membership (only the "holding" of shares, which has nothing to do with membership, is so dealt with), H Co can conveniently avoid these important consequences by simply not being a member of S Co. It can "hold" its shares through a nominee who will be the member."

¹⁵ In general see *Unisec* above.

either alone or through its subsidiaries,¹⁶ the focus of the new definition shifted slightly to the question of who held the majority voting rights or who could appoint/dismiss the directors with majority of votes at meetings of the board of directors. Despite criticism¹⁷ the new definition¹⁸ not only still contained the requirement of membership but in fact opened the gate to (potentially) more abuse. Under the previous definition, a company

¹⁶ Haydock “The Effect of the Amendments to the Definition of a Subsidiary in the Companies Amendment Act 82 of 1992” (1993) *SA Merc LJ* 166.

¹⁷ *Unisec* above.

¹⁸ S 1(3) as amended in 1992 read: For the purposes of this Act, a company shall be deemed to be a subsidiary of another company if-

- (i) that other company is a member of it and-
 - (aa) holds a majority of the voting rights in it; or
 - (bb) has the right to appoint or remove directors holding a majority of the voting rights at meetings of the board; or
 - (cc) has the sole control of a majority of the voting rights in it, whether pursuant to an agreement with other members or otherwise; or
 - (ii) it is a subsidiary of any company which is a subsidiary of that other company; or
 - (iii) subsidiaries of that other company or that other company and its subsidiaries together hold the rights referred to in subparagraph (i) (aa), (bb) or (cc).
- (b) In determining whether a company holds the majority of the voting rights as contemplated in paragraph (a) (i) (aa)-
- (i) voting rights which are exercisable only in certain circumstances shall be taken into account only-
 - (aa) when those circumstances have arisen, and for so long as they continue; or
 - (bb) when those circumstances are under the control of the person holding the voting rights;
 - (ii) voting rights held by a person in a fiduciary capacity shall be treated as not held by him but by the beneficiary of such voting rights;
 - (iii) voting rights held by a person as nominee for another person shall be treated as not held by him but by that other person, and voting rights shall be deemed to be held by a nominee for another person if they are exercisable only on the instructions or with the consent or concurrence of that other person.
- (c) A body corporate or other undertaking which would have been a subsidiary of a company had the body corporate or other undertaking been a company shall be deemed to be a subsidiary of that company.
- (cA) For the purposes of this subsection 'hold' or any derivative thereof refers to the registered or beneficial holder (direct or indirect) of shares conferring a right to vote.”

would only be a holding company of the subsidiary in a situation where it controlled the composition of the board, if the first mentioned company was a member of the last mentioned company. Where a company had the majority equity shares in another company, the first-mentioned company would be the holding company of the other company, regardless of the fact that it was not necessarily a member of that company. In terms of the 1992 amendment, the requirement of membership was included also where a company had the majority of voting rights.

The most recent development in company law is the passing of the new Companies Act¹⁹ in December 2008 by the South African parliament. The new Companies Act will commence on a date to be fixed by the president by proclamation in the Government Gazette, which may, however, not be earlier than one year from the date on which the president signed the new Companies Act, namely 8 April 2009.

The new Companies Act has made changes to the current definitions of holding and subsidiary companies as well as to the consequences of such relationship. A holding company is defined in relation to a subsidiary, as meaning “a juristic person or undertaking that controls that subsidiary.”²⁰

The new Companies Act defines a subsidiary company as follows:

“3. (1) A company is—

- (a) a subsidiary of another juristic person if that juristic person, one or more other subsidiaries of that juristic person, or one or more nominees of that juristic person or any of its subsidiaries, alone or in any combination—
 - (i) is or are directly or indirectly able to exercise, or control the exercise of a majority of the general voting rights associated with issued securities of that company, whether pursuant to a shareholder agreement or otherwise; or
 - (ii) has or have the right to appoint or elect, or control the appointment or election of, directors of that company who control a majority of the votes at a meeting of the board;
- or

¹⁹ 71 of 2008.

²⁰ S 1 of the new Companies Act.

- (b) a wholly-owned subsidiary of another juristic person if all of the general voting rights associated with issued securities of the company are held or controlled, alone or in any combination, by persons contemplated in paragraph (a).
- (2) For the purpose of determining whether a person controls all or a majority of the general voting rights associated with issued securities of a company—
 - (a) voting rights that are exercisable only in certain circumstances are to be taken into account only—
 - (i) when those circumstances have arisen, and for so long as they continue; or
 - (ii) when those circumstances are under the control of the person holding the voting rights;
 - (b) voting rights that are exercisable only on the instructions or with the consent or concurrence of another person are to be treated as being held by a nominee for that other person; and
 - (c) voting rights held by—
 - (i) a person as nominee for another person are to be treated as held by that other person; or
 - (ii) a person in a fiduciary capacity are to be treated as held by the beneficiary of those voting rights.
- (3) For the purposes of subsection (2), ‘hold’, or any derivative of it, refers to the registered or direct or indirect beneficial holder of securities conferring a right to vote.”²¹

A group of companies is also defined in the new Companies Act, albeit not in an entirely elegant and logical manner. The phrase means “two or more companies that share a holding company or subsidiary relationship.”²²

A new aspect of the new Companies Act is the definition of a juristic person within the context of a holding company / subsidiary company relationship. According to the new Companies Act a juristic person includes a trust.²³ In terms of the definition of a subsidiary company in the new Companies Act a trust can now be the holding company of another company which in terms of the 1973 Act is not possible.

Another new aspect of the statutory provisions regarding groups of companies is the terms “related” and “inter-related” persons. “Related” means “when used in respect of

²¹ Section 3.

²² Section 1 of the new Companies Act.

²³ Section 1 of the new Companies Act “juristic person” includes - ... “(b) a trust, irrespective of whether or not it was established within or outside the Republic;”

two persons, ... persons who are connected to one another in any manner contemplated in section 2(1)(a) to (c).”²⁴ The term “inter-related” is defined in the definitions section of the new Companies Act as follows:

“when used in respect of three or more persons, means persons who are related to one another in a series of relationships, as contemplated in section 2(1)(d).”²⁵

However, apparently through an oversight, the new Companies Act, as approved by parliament, contains no section 2(1)(d).²⁶

Regarding the question of whether a juristic person is related to another juristic person the new Companies Act provides that:

“2. (1) For all purposes of this Act—

(c) a juristic person is related to another juristic person if—

- (i) either of them directly or indirectly controls the other, or the business of the other, as determined in accordance with subsection (2);
- (ii) either is a subsidiary of the other; or
- (iii) a person directly or indirectly controls each of them, or the business of each of them, as determined in accordance with subsection (2).

(2) For the purpose of subsection (1), a person controls a juristic person, or its business, if—

(a) in the case of a juristic person that is a company—

- (i) that juristic person is a subsidiary of that first person, as determined in accordance with section 3(1)(a); or
- (ii) that first person together with any related or inter-related person, is—
 - (aa) directly or indirectly able to exercise or control the exercise of a majority of the voting rights associated with securities of that company, whether pursuant to a shareholder agreement or otherwise; or
 - (bb) has the right to appoint or elect, or control the appointment or election of, directors of that company who control a majority of the votes at a meeting of the board;

²⁴ See below.

²⁵ S 1 of the new Companies Act.

²⁶ S 2(1)(d) of the Companies Bill B61-2008 defined “inter-related” as follows: “Three or more persons are inter-related if the first and second such persons are related, the second and third such persons are related, and so forth in an unbroken series.” An attempt has been made to remedy the omission by inserting the aforementioned definition into the draft regulations of 26 January 2010. Regulation 3(6) deals with “interpretation” and authority for this power to draft this regulation, amongst others, is allegedly provided by s 223(1)(d)(ii) of the new Companies Act which provides that the relevant minister may make regulations in respect of “any ancillary or incidental matter that is necessary for the proper implementation and administration of this Act.” Whether this attempt to insert a substantive matter into the new Companies Act by means of a regulation is lawful is not entirely clear.

- (b) in the case of a juristic person that is a close corporation, that first person owns the majority of the members' interest, or controls directly, or has the right to control, the majority of members' votes in the close corporation;
- (c) in the case of a juristic person that is a trust, that first person has the ability to control the majority of the votes of the trustees or to appoint the majority of the trustees, or to appoint or change the majority of the beneficiaries of the trust; or
- (d) that first person has the ability to materially influence the policy of the juristic person in a manner comparable to a person who, in ordinary commercial practice, would be able to exercise an element of control referred to in paragraph (a), (b) or (c).²⁷

The new Companies Act contains a further provision of relevance in respect of related or inter-related parties. The new Companies Act provides that:

“With respect to any particular matter arising in terms of this Act, a court, the Companies Tribunal or the Panel may exempt any person from the application of a provision of this Act that would apply to that person because of a relationship contemplated in subsection (1) if the person can show that, in respect of that particular matter, there is sufficient evidence to conclude that the person acts independently of any related or inter-related person.”²⁸

At first blush it is not entirely clear what the purpose of the above provision is. It could conceivably be a reflection of the definitions of related and inter-related being phrased widely to prevent abuse and therefore to provide for exemptions in deserving cases. The new Companies Act contains a general section which, for example, allows for exemptions from the provisions of the Act.²⁹ The relevant section also attempts to address anti-avoidance measures which may be taken, for example an attempt to avoid falling under the definition of a related or inter-related party, but substantively being a related or inter-related person.³⁰

Membership as a pre-condition for a holding company–subsidiary company relationship has been removed. The definitions in the new Companies Act are otherwise very similar

²⁷ S 2(1)(c)-2(2).

²⁸ S 2(3).

²⁹ S 6(2). This section will conceivably operate parallel to s 2(3).

³⁰ S 6(1). Assume, for example, that company A can appoint the majority of directors of company B which would make company B a subsidiary of company A in terms of s 3(1)(a)(ii). Company A “relinquishes” that right by allowing its legal advisor to appoint a number of directors in company B, the effect of which is that company A does not appoint the majority of directors of company B anymore. Such a scheme could conceivably be deemed to be an anti-avoidance arrangement in terms of s 6(1).

in principle to the definitions of subsidiary company in the 1973 Act, apart from the removal of the requirement of membership of the subsidiary company.³¹ Regarding the power of a company to control the board of the subsidiary, the new Companies Act does not mention the power to appoint or dismiss the directors who control the majority of votes at a board meeting like the 1973 Act, but merely mentions the power to appoint the directors who control the majority of voting rights at a board meeting.³² It does not appear to be a fundamental change, however.

The definition of a wholly-owned subsidiary company is, however, rather peculiar.³³ This peculiarity can be illustrated by the following example. Assume that company A holds 51% of the voting rights in company B. Company B holds 50% of the voting rights in company C and the remaining 50% is held by company A. Company C is now in terms of the definition a wholly-owned subsidiary company of company A. In terms of the 1973 Act, company B had to be wholly-owned subsidiary company of Company A for company C to be a wholly-owned company of company A. It is submitted that the definition in the 1973 Act made more sense than the definition in the new Companies Act.

5.3 Recognition of company groups in the 1973 Act and the new Companies Act

The 1973 Act does not specifically recognise the concept of a group as such, but it does attach certain consequences to the relationship between a holding company and a subsidiary company. This recognition takes on a variety of forms, from provisions to prevent the abuse of the group relationship and then also financial disclosure measures within a group of companies. The new Companies Act also attaches a number of consequences arising from the relationship between a holding company and its subsidiary company.

³¹ Above.

³² S 3(1)(a)(ii).

³³ S 3(1)(b).

5.3.1 Accounting standards within company groups

The 1973 Act requires a holding company to compile group financial statements as a means of disclosing the financial position of the group.³⁴ The 1973 Act, for purposes of disclosure of the group financial statements, therefore treats the group as a single economic unit. The 1973 Act, however, does not thereby deny the separate juristic entities within the group. The 1973 Act specifically provides that if the directors of a holding company are of the opinion that the business of the company and that of a subsidiary are so different that they cannot reasonably be treated as a single undertaking, group annual financial statements need not deal with that subsidiary if the Registrar approves the omission.³⁵ It is clearly implied here that the 1973 Act does recognise the single economic unit in respect of annual financial statements but without disregarding the separate juristic personality of each component within the single economic unit.

The new Companies Act, however, does not make express reference to accounting records and the requirements for financial statements of a group of companies.³⁶ However, the new Companies Act provides that the relevant minister may make regulations prescribing financial reporting standards.³⁷ In terms of the draft regulations the minister has determined that the International Financial Reporting Standards will be the applicable reporting standard.³⁸ The International Financial Reporting Standards makes provision for consolidated group financial statements.³⁹

The new Companies Act provides in respect of the annual financial statements of groups that:

“The annual financial statements of a company must—
(a)...;
(b) include a report by the directors with respect to the state of affairs, the business and profit or loss of the company, or of the group of companies, if the company is part of a group, including—

³⁴ Ss 288-294.

³⁵ S 291(2)(b).

³⁶ See, however, s 115(2)(b)(ii), para 5.3.8 below, as an example of a provision which assumes such statements exist.

³⁷ S 29(4).

³⁸ Regulation 28 of the draft regulations of 26 January 2010.

³⁹ S 29(4)(a). See International Accounting Standard (IAS) 27, “Consolidated and separate financial statements”, read with IAS 1.

- (i) any matter material for the shareholders to appreciate the company's state of affairs; and
- (ii) any prescribed information.”⁴⁰

The new Companies Act also provides for the disclosure of directors' remuneration within the context of a group of companies.⁴¹

5.3.2 Loans made and securities within company groups

There are a number of sections in the 1973 Act and the new Companies Act which regulate the potential abuse that could take place within a group of companies. Funds of the subsidiary can be misused by means of loans to directors of the holding company or to directors of other companies within the group,⁴² the funds of the subsidiary could be used to assist persons who wish to obtain shares⁴³ in the holding company and the holding company may force its subsidiary to make loans to it or to other companies within the group on disadvantageous terms to the subsidiary company. These provisions will now be briefly discussed.

Section 37 of the 1973 Act deals with loans made and security which is provided by a subsidiary to its holding company, or to a subsidiary of its holding company, but excludes loans or security to a subsidiary of itself.⁴⁴ Section 37 specifically covers loans⁴⁵ by a subsidiary to its holding company and to a subsidiary of its holding company, via intermediaries.⁴⁶ Loans have a broad meaning.⁴⁷ Security is also defined as including a

⁴⁰ S 30(3)(b)

⁴¹ Article 30(5)(b)(ii) provides that “[t]he information to be disclosed under subsection (4) must satisfy the prescribed standards, and must show the amount of any remuneration or benefits paid to or receivable by persons in respect of—

(a) ...; or

(b) services rendered while being directors or prescribed officers of the company—

(i) as directors or prescribed officers of any other company within the same group of companies; or

(ii) otherwise in connection with the carrying on of the affairs of the company or any other company within the same group of companies.

⁴² S 37 of the 1973 Act and s 45(2) of the new Companies Act.

⁴³ S 44 of the new Companies Act applies more widely to financial assistance for the acquisition of securities as defined.

⁴⁴ S 37(1)(a)(i) and (ii).

⁴⁵ As well as the provision of security.

⁴⁶ Compare s 226 in respect of direct and indirect loans and *S v Pouroulis* 1993 4 SA 575 (W).

⁴⁷ S 37(4)(b) provides that a loan may include any credit extended by a company, if the debt concerned is not payable or being paid in accordance with the normal business practice of the company in respect of the payment to it of other debts of the same kind.

guarantee.⁴⁸ It is clear that neither definition is intended to be exhaustive but rather to include forms of loan or security respectively that ordinarily may not be covered by those terms in the strict sense. Regarding loans, section 37 also focuses on the funds of the company which are used as a loan. Funds are also widely defined as including money, shares, debentures or any other property.⁴⁹ According to Blackman⁵⁰ one should not read section 37 in isolation but should read it in conjunction with the provisions of section 226 of the 1973 Act regarding loans to directors,⁵¹ the common-law duties of directors, namely their fiduciary duties and duty of care and skill, as well as the provisions of the Insolvency Act⁵² which deal with dispositions by debtors (in this context companies) where such debtors received no value in return for the dispositions.

Initially the 1926 Companies Act prohibited loans by a company to its holding company.⁵³ The section that provided for the prohibition was then amended to allow loans by wholly owned subsidiaries to their holding companies if all the members of the company gave their consent to the loan.⁵⁴ It is clear that the legislature accepted that sound business reasons may exist for the making of loans within a group of companies.⁵⁵ The original section 37 of the 1973 Act was, however, also drafted restrictively in respect of intergroup loans and in 1974 a new section 37 was introduced which in turn was replaced by the current section 37 in 1977.⁵⁶

Section 37(1) of the 1973 Act requires that details of any loan⁵⁷ made by a subsidiary to its holding company, or to a subsidiary of its holding company, but excluding its own subsidiary, must be disclosed in the annual financial statements of the lending company for every year that the loan exists. However, the right to disclosure may be waived by the members of the lending company should all the members of the company agree to such

⁴⁸ S 37(4)(c).

⁴⁹ S 37(4)(a).

⁵⁰ Blackman et al *Commentary on the Companies Act* 4-53.

⁵¹ See para 5.3.5 below.

⁵² Act 24 of 1936.

⁵³ S 86*bis*(1).

⁵⁴ S 69 Companies Amendment Act 46 of 1952.

⁵⁵ Millin Commission of Enquiry on the Amendment of the Companies Act Report 1947-8 UG No 69-1948 46.

⁵⁶ Blackman et al *Commentary* 4-53.

⁵⁷ S 37(10) also applies to the giving of security by the subsidiary company.

waiver.⁵⁸ This is surprising since one would assume that the disclosure provisions are not only there for the protection of minority shareholders of the company but also for the protection of creditors of that company.

The disclosure requirements of the sections are also not applicable where the loan or security, as the case may be, was provided *bona fide* in the ordinary course of the business of a company actually and regularly carrying on a business of which a substantial part is the making of loans or the provision of security, as the case may be.⁵⁹

Besides the disclosure requirements, section 37 also imposes liability in certain circumstances on the directors responsible for making the loan or providing security. Should a subsidiary make a loan or provide security, as the case may be, to its holding company or to a subsidiary of its holding company on terms that were not fair to the first-mentioned company, or failed to provide reasonable protection to its business interests at the time of the making of the loan or the provision of the security, the directors who authorised the loan could be held liable for any damages that the company may have suffered due to the making of the loan or the provision of the security.⁶⁰ The section lists a number of examples of what could conceivably not provide reasonable protection to the business interests of the company or what could be unfair.⁶¹

It is interesting to note that “directors” as mentioned in this context includes the directors of the holding company.⁶² This statutory liability is in addition to any other rule of law relating to the liability of a director or officer of the company.⁶³ In terms of the common law, a director only has a fiduciary duty towards the company of which he is a director and the duty of care and skill also only applies to the company of which he is a director. Section 37 therefore extends the common-law liability of a director to a director of the

⁵⁸ S 37(5).

⁵⁹ S 37(1)(b).

⁶⁰ S 37(3)(a).

⁶¹ S 37(3)(c).

⁶² S 37(3)(b) read with s 37(3)(a).

⁶³ S 37(3)(d).

holding company.⁶⁴ Should all the members of the company, however, consent to the loan or security, as the case may be, there shall be no liability for the directors even if the subsidiary company is prejudiced.⁶⁵ Such consent must be prior consent.⁶⁶

The new Companies Act also deals with loans and securities which companies within groups provide to other group members.⁶⁷ The new Companies Act provides that a company may only provide financial assistance⁶⁸ to a related or inter-related company,⁶⁹ under certain circumstances.⁷⁰ These circumstances are firstly that the board of directors of the company, giving financial assistance, may only provide such assistance to the related or inter-related company if the shareholders of the lending company adopted a special resolution within the preceding two years, either authorising the specific transaction or generally approving a category of recipients, and the recipient falls within that category,⁷¹ and the board of the lending company is satisfied that the company would satisfy the solvency and liquidity test⁷² immediately after the provision of the financial assistance.⁷³ Furthermore, if the memorandum of incorporation of the company sets out any further requirements or conditions for the granting of financial assistance, these also have to be satisfied.⁷⁴ If the directors of the company approve of such financial assistance, the company has to give written notice of the assistance to all its shareholders and to any trade union which represents the employees of the company if the total value of the assistance and of all financial assistance during the course of that financial year

⁶⁴ Blackman et al *Commentary* 4-54.

⁶⁵ S 37(5).

⁶⁶ Naude "Loans or security by subsidiaries: The new section 37 and abuse of control" 1979 *MBL* 8 14, Blackman et al *Commentary* Revision Service 6 (2009) 4-55. See in general Naude for a detailed discussion of s 37 of the 1973 Act.

⁶⁷ S 45.

⁶⁸ Financial assistance is defined in s 45(1) and includes loans, the provision of security and the guaranteeing of a loan. The definition is, however, not exhaustive.

⁶⁹ See above for the definitions of related and inter-related. This definition therefore includes financial assistance by one group member to another group member, including financial assistance by a holding company to its subsidiary. If a subsidiary company finds itself in financial difficulty, the holding company or other related or inter-related companies may only assist it if the last-mentioned companies are solvent and liquid. This requirement can have severe consequences for the creditors of the subsidiary although the creditors of the holding company, for example, are protected.

⁷⁰ S 45(2) read with s 45(3) and s 45(4).

⁷¹ S 45(3)(a)(ii).

⁷² The solvency and liquidity test is defined in s 4 of the new Companies Act.

⁷³ S 45(3)(b).

⁷⁴ S 45(4).

exceeds one tenth of 1% of the company's net value at the time of the board resolution.⁷⁵ Non-compliance with these requirements could result in the resolution of the board authorising financial assistance being declared void by a court,⁷⁶ and which could lead to personal liability for the directors.⁷⁷ There is also a general fiduciary duty on the directors of a company not to use their position to cause harm to the company or to a subsidiary of the company of which they are directors.⁷⁸

The provisions in respect of inter-group financial assistance in the new Companies Act are stricter than those in the 1973 Act. Whereas the 1973 Act merely requires disclosure, the new Companies Act requires compliance with procedural requirements⁷⁹ and also protects creditors.⁸⁰ Whereas non-compliance of the provisions in respect of financial assistance within groups does not cause the assistance to be void in terms of the final version of the 1973 Act, the new Companies Act provides that non-compliance can result in the financial assistance being declared void by the court.

It is noteworthy that should a subsidiary provide the financial assistance, the new Companies Act does not expressly require the subsidiary to disclose such assistance in its annual financial statements as is required by the 1973 Act. One may assume that the reason for the absence of such provision in the new Companies Act is that creditors of the subsidiary company are protected by the requirement of solvency and liquidity after the transaction takes place and the minority shareholders of the subsidiary company are protected by the requirement that a special resolution is required. However, an equally good argument could be made that disclosure by the subsidiary company of such loan or security would assist to encourage compliance with solvency and liquidity.⁸¹

⁷⁵ S 45(5).

⁷⁶ S 45(6) read with s 218(1).

⁷⁷ S 45(7).

⁷⁸ S 76(2)(a)(ii).

⁷⁹ A special resolution by the shareholders.

⁸⁰ By means of the solvency and liquidity requirement.

⁸¹ See IAS 24.17, 24.18 and 24.20 which requires disclosure of transactions within groups.

5.3.3 Financial assistance for the acquisition of securities of the company or of a related company

Section 38 of the 1973 Act prohibits a subsidiary from granting financial assistance directly or indirectly to a person to obtain shares in itself or in its holding company.⁸² The financial assistance may not be for the purpose of or in connection with a purchase or subscription made or to be made by any person of or for any shares of the relevant company. Financial assistance includes a loan, guarantee, the provision of security or otherwise.⁸³

The reason for the introduction of section 38 of the Act was to prevent persons who did not possess sufficient funds to gain control of a company on the basis that they would use the funds or creditworthiness of the company to finance the acquisition of shares in the company.⁸⁴ The potential for abuse is obvious. The directors of the holding company could exercise their influence over the directors of the subsidiary to obtain funds to purchase shares in the holding company or the subsidiary company.⁸⁵

Section 38 provides for certain exceptions when a company will be allowed to give financial assistance for the purchase of shares in itself or its holding company.⁸⁶ Should the subsidiary contravene the prohibition contained in section 38(1) of the 1973 Act, the company as well as every director or officer of the company shall be guilty of an offence.⁸⁷ The contract that provides for the granting of financial assistance will be void as will be all ancillary obligations.⁸⁸

One of the most important reasons for the introduction of section 38 in the 1973 Act was to confirm one of the pillars of the common law, namely the capital maintenance rule in terms of which the funds of the company have to be protected for the benefit of creditors

⁸² For a detailed analysis of s 38 see Brincker *Die Verbod op die Verlening van Geldelike Bystand deur 'n Maatskappy by die Verkryging van sy Aandele*, LLD dissertation, University of Stellenbosch 1991.

⁸³ S 38(1).

⁸⁴ Blackman et al *Commentary* 4-56 with reference to the Jenkins Committee Report 1749 of 1962.

⁸⁵ Botha *Groups in South African Company Law* LLD dissertation, University of Pretoria 1981 183.

⁸⁶ S 38(2).

⁸⁷ S 38(3).

⁸⁸ *Lipschitz NO v UDC Bank Ltd* 1979 1 SA 789 (A) 808.

and minority shareholders.⁸⁹ The traditional rules in respect of capital maintenance have, however, in the recent past been substantially amended to allow, for example, the payment of dividends out of capital under certain circumstances⁹⁰ as well as the possibility that a company may buy back its own shares under certain conditions.⁹¹ Section 38 in a sense became one of the last outposts of the capital maintenance rule and its continued existence became increasingly anachronistic.⁹²

Mainly because of the increasingly anachronistic nature of section 38, coupled with the problems that the section creates for black economic empowerment, the 1973 Act was amended by creating an additional exception, which allows a company to give financial assistance for the purchase of or subscription for shares of that company or its holding company if the company's board is satisfied that, subsequent to the transaction, the company will be solvent and liquid, as defined.⁹³

Section 38 of the 1973 Act will be replaced by section 44 of the new Companies Act. The latter section allows a company to provide financial assistance, subject to certain requirements, to any person for the subscription of "any option, or any securities, issued or to be issued by the company or a related or inter-related company, or for the purchase of any securities of the company or a related or inter-related company".⁹⁴ Section 38 of the 1973 Act, in the context of a group of companies, only applied to financial assistance by a subsidiary company to a person for the acquisition of shares in the holding company. Section 44 of the new Companies Act has a broader ambit since it applies to related and inter-related companies as well. Financial assistance by a company within a group to a person for the acquisition of securities in another company within the group will

⁸⁹ *Peters v Schoeman* 2001 1 SA 872 (SCA) 881.

⁹⁰ S 90.

⁹¹ S 85.

⁹² Blackman et al *Commentary* 4-58.

⁹³ S 9 of the Corporate Laws Amendment Act 24 of 2006 inserting s 38(2A) into the 1973 Companies Act. The Act was passed on 17 April 2007 and came into effect on 14 December 2007.

⁹⁴ S 44(2). In terms of s 44(3) some of the requirements are that the board of the company has to be satisfied that the company would satisfy the solvency and liquidity test, the shareholders must have approved the assistance by means of a special resolution either generally or for a specific transaction, the financial assistance and the terms of the assistance have to be fair and reasonable to the company. In terms of s 44(4) the memorandum of incorporation can also set out certain requirements which have to be satisfied. See also para 5.3.6 below for a brief discussion of the solvency and liquidity requirement.

therefore now be subject to the provisions of section 44 as well, for example financial assistance by a holding company to persons, so that they can acquire a minority shareholding in the subsidiary.

5.3.4 Subsidiary holding shares in the holding company

Section 39(1) of the 1973 Act was substituted by section 4(a) of Act 37 of 1999. Prior to 1999 there was a prohibition on membership by a subsidiary of its holding company except in a few circumstances. This was an extension of the common-law rule that a company may not purchase its own shares.⁹⁵ Once the legislature allowed a company to purchase its own shares,⁹⁶ the prohibition became obsolete and had to be amended as well.

Section 39 of the 1973 Act has to be read with section 89 of the 1973 Act. Section 89 of the 1973 Act provides that a subsidiary may acquire shares in its holding company up to a maximum of 10% in the aggregate of the number of issued shares of the holding company.⁹⁷ Section 39, as amended, provides that the voting rights that are attached to the shares that a subsidiary may acquire in the holding company in that way may not be exercised as long as the shares are held by the subsidiary and that the percentage of votes that can be cast at a meeting of shareholders shall be reduced by the number of shares that the subsidiary holds.⁹⁸

It would appear that these provisions only apply to the acquisition of shares by a subsidiary in its holding company after it became a subsidiary. Shares that the subsidiary held in its holding company prior to it becoming a subsidiary are therefore not affected by the restrictions and therefore still carry voting rights.⁹⁹

⁹⁵ *Trevor v Whitworth* (1887) 12 App Cas 409 (HL).

⁹⁶ Ss 85-89 of the 1973 Act, as substituted by ss 9 to 13 of the Companies Amendment Act 37 of 1999.

⁹⁷ Section 89 also provides that the acquisition by the subsidiary of shares in the holding company has to be *mutatis mutandis* in accordance with sections 85 to 88 of the 1973 Act.

⁹⁸ s 39 (1)(a) and (b).

⁹⁹ Blackman et al *Commentary* 4-68.

The new Companies Act also regulates the acquisition by a subsidiary company of shares in its holding company.¹⁰⁰ The new Companies Act provides that a subsidiary company may acquire shares in its holding company, but that it or it and other subsidiaries, may not hold more than 10% of the issued shares of the holding company.¹⁰¹ The shares held by a subsidiary will also not carry any voting rights.¹⁰² The provisions of section 48(2)(b) of the new Companies Act would appear to mean that a subsidiary may not hold more than 10% of the issued shares of the company. This is different to the 1973 Act which provides that a subsidiary may not acquire more than 10% of the issued shares of the holding company. Shares which a company held before it became a subsidiary are therefore not included under the 1973 Act whereas those shares would now be included.¹⁰³ The new Companies Act however uses the term “not more than 10% [...] of any class” of shares.¹⁰⁴ This would imply that should a company, for example, have four different classes of shares, the subsidiary could hold 10% of the issued shares in each class since it would in the aggregate still only hold 10% of the total number of issued shares of the company. A director who does not vote against an acquisition by a subsidiary company of shares in the holding company which contravenes the new Companies Act could be held liable by the company for damages suffered by it as a result of the contravention.¹⁰⁵ It would appear that the aims of the provisions are to prevent the abuse of voting rights and to restrict trafficking in the shares of the holding company. It is also clear that the subsidiary does not have to comply with the solvency and liquidity requirements.¹⁰⁶

5.3.5 Prohibition of loans to, or security in connection with transactions by, directors and managers

Potentially one of the easiest forms of abuse within a group of companies is the utilisation of the funds of the subsidiary to provide loans to directors of the company or to

¹⁰⁰ S 48.

¹⁰¹ S 48(2)(b)(i).

¹⁰² S 48(2)(b)(ii).

¹⁰³ It is not clear whether s 48 requires the subsidiary to dispose of any shares in excess of 10% should the subsidiary have held more than 10% before becoming a subsidiary.

¹⁰⁴ S 48 (2)(b)(i).

¹⁰⁵ S 48(7) read with s 77(3)(e)(vii).

¹⁰⁶ S 48(2)(a) expressly limits the application by the solvency and liquidity tests to a company which acquires its own shares.

its holding company or to directors of fellow subsidiaries within the group. The assets of the subsidiary could also be at risk since these could be used as security for loans by the abovementioned directors. Section 226 of the 1973 Act therefore regulates certain loans and the provision of security to certain directors and undertakings controlled by them.¹⁰⁷

The purpose of this provision is:

“[T]o prevent directors or managers of a company acting in their own interests and against the interests of shareholders by burdening the company with obligations which are not for its benefit but are for the benefit of another company and/or for the benefit of its directors and/or managers.”¹⁰⁸

To prevent the circumvention of this prohibition, the 1973 Act also prohibits the lending of money by a company to a company or another body corporate that is controlled by one or more directors or managers of the company, its holding company or a company that is a subsidiary of the holding company of the lending company.¹⁰⁹ The provision does not, however, prevent a company from lending, for example, to its holding company or to a subsidiary of its holding company or to its own subsidiary regardless whether the holding company, for example, is controlled by a director, who would ordinarily fall under the prohibition.¹¹⁰

A company may also lend money or grant security to its own director or manager or to a company or other body corporate that is controlled by one or more of the directors or managers of the company provided that the prior consent of the members of the company is obtained in the form of a special resolution or by means of unanimous consent.¹¹¹ A loan to or the provision of security for a director of the holding company or to a body corporate controlled by that director or to a director of a fellow subsidiary or to a body

¹⁰⁷ A detailed discussion of the intricacies of s 226 and its interaction with s 37 of the 1973 Act is beyond the realm of this dissertation. For a detailed discussion of s 226 of the 1973 Act refer to Jooste “Loans to directors – analysis of s 226 of the Companies Act” 2000 *SA Merc LJ* 269.

¹⁰⁸ *Standard Bank of South Africa Ltd v Neugarten and Others* 1988 1 SA 652 (W) 658F-G, see also *Neugarten and Others v Standard Bank of South Africa Ltd* 1989 1 SA 797 (A) 802A-C and *S v Pouroulis and Others*. 1993 4 SA 575 (W).

¹⁰⁹ S 226(1)(b).

¹¹⁰ See s 37 above read with s 226(1B).

¹¹¹ See s 226(2)(a)(i)-(iv).

corporate controlled by that director is absolutely prohibited, i.e. the loan or the provision of security is not possible even with a special resolution or unanimous consent. A company may also lend money to a director or manager of its subsidiary company provided that that director or manager is not a director or manager of the lending company itself.¹¹²

In *Bevray Investments (Edms) Bpk v Boland Bank Bpk*¹¹³ the interpretation of the phrase “own director” in this context¹¹⁴ required judicial clarification. The simplified facts were that a certain Voges was a director of the applicant but also of the holding company of the applicant. The applicant then provided security for the obligations of Voges to the respondent. When Voges defaulted on his obligations to the respondent it wanted to exercise its security that was provided by the applicant. The applicant alleged that the security was prohibited because Voges was a director of the holding company.¹¹⁵ The respondent alleged that an exception covered the transaction.¹¹⁶ The court therefore had to decide whether “own director” meant that the director may only be a director of the lending company (and not a director of a company where the prohibition would be applicable) for the exception to apply or whether other directorships were irrelevant as long as he is an “own director” of the lending company.

Botha JA in a well reasoned minority decision illustrated the mischief at which the prohibition is aimed by means of the following example. He gave the example of a loan by a subsidiary to a director of the subsidiary, where this director is also a director of the holding company of the lending company.¹¹⁷ Botha JA then explained the situation as follows:

“Maatskappy I

¹¹² S 226(2)(f).

¹¹³ *Bevray Investments (Edms) Bpk v Boland Bank Bpk en Andere* 1993 3 SA 597 (A).

¹¹⁴ S 226(2)(a).

¹¹⁵ S 226(1)(a)(ii) prohibits the provision of security by a subsidiary company to a director of its holding company.

¹¹⁶ S 226(2)(a)(ii) provides that a company may provide security to a director of the company subject to a special resolution or the prior unanimous consent of the shareholders of the company.

¹¹⁷ 609.

houermaatskappy; direkteure A en B E	
Maatskappy II	Maatskappy III
filiaal van I;	filiaal van I;
direkteure A en C	direkteure A en D

Die posisie is nou dat maatskappy II steeds verbied word, volgens subart (1)(a)(ii) en (iii), om 'n lening te maak aan B en D, en dat die toestemming van die aandeelhouders van maatskappy II tot so 'n lening nie die toepaslikheid van die verbod uitkakel nie; subart (2)(a)(i) en (ii) kan steeds nie in werking tree nie. Wat dan van 'n lening deur maatskappy II aan A? Die argument namens die Bank is dat subart (2)(a)(i) en (ii) die uitwerking het dat maatskappy II wel met die toestemming van sy aandeelhouders 'n lening mag maak aan A. Maar dit is klaarblyklik absurd. Geen bestaansrede vir so 'n resultaat is denkbaar nie. Die ratio van die verbod op 'n lening deur maatskappy II aan B of D, sonder uitsondering, is steeds ten volle van toepassing ook op 'n lening deur maatskappy II aan A. Inderdaad is die rede vir die verbod nog sterker aanwesig in A se geval, vanweë sy direkte magposisie teenoor maatskappy II as direkteur van daardie maatskappy, om tot eie voordeel die fondse van die maatskappy te gebruik. Die Wetgewer se oogmerk om die belange van die aandeelhouders van maatskappy I te beskerm teen die wanaanwending van maatskappy II se fondse deur B of D, vereis met groter krag dat daar 'n verbod moet wees in die geval van 'n lening aan A. Die toestemming van die lede van maatskappy II tot 'n lening aan A kan nog minder die beskerming van die aandeelhouders van maatskappy I onnodig maak as in die geval van 'n lening deur maatskappy II aan B of D. As die argument namens die Bank oor die betekenis van subart (2)(a)(i) en (ii) reg is, sou dit beteken dat die Wetgewer die verbod wat hy met die een hand in subart (1)(a)(ii) en (iii) tot stand gebring het, eensklaps met die ander hand weer tot groot hoogte ongedaan gemaak het in subart (2)(a)(i) en (ii). Die euwel wat die Wetgewer in subart (1)(a)(ii) en (iii) bestry het met betrekking tot direkteure van houer- en filiaalmaatskappye, sou hy dan weer deur middel van subart (2)(a)(i) en (ii) grootliks laat herleef het. Dit sou 'n sinlose en onsinnige resultaat wees. Na my oordeel is dit ondenkbaar dat dit die bedoeling van die Wetgewer kon gewees het.”¹¹⁸

The majority, however, held that the exception in section 226(2)(a)(ii) covered the facts in point regardless of the fact that Voges was also a director of the holding company which would ordinarily fall foul of section 226(1)(a)(ii). The majority sets out the court’s approach to the interpretation of section 226 in the following terms:

”Die breë oogmerk of oogmerke van die bepaling is natuurlik duidelik. Maatskappye word bestuur deur direkteure en bestuurders. Hierdie direkteure en bestuurders kan hul bevoegdhede misbruik

¹¹⁸ 609B-J. The reasoning of Botha JA is essentially that the arguments of the bank would lead to absurd results where a loan is made by company II to director A because A can abuse his position as director of company II.

vir hul eie voordeel. Daarbenewens kan die direkteure of bestuurders van houermaatskappy hulself onbehoorlik bevoordeel deur hul beheer oor filiaalmaatskappye. Die Wetgewer wou die moontlikheid van sulke wanpraktyke beperk. Die Wetgewer het egter nie hierdie oogmerk probeer verwesenlik deur 'n algemene of absolute verbod te plaas op alle transaksies tussen 'n bestuurder of direkteur en 'n betrokke maatskappy waardeur die bestuurder of direkteur bevoordeel kan word nie. Klaarblyklik sou so 'n verbod onprakties wees. Daar moet noodwendig baie omstandighede wees waarin dit nie onbehoorlik is vir 'n direkteur of bestuurder om geldelike voordele te ontvang van die maatskappy wat hy bestuur of wat deur sy maatskappy beheer word nie. Die Wetgewer het homself dus beperk tot 'n verbod op sekere bepaalde transaksies wat as *prima facie* onaanvaarbaar beskou is, nl die maak van sekere lenings en die voorsiening van sekere sekuriteite. Selfs hier is die verbod egter nie absoluut nie - sekere transaksies wat binne die trefwydte van die verbod val, was nogtans vir die Wetgewer aanvaarbaar. Om vir sulke transaksies voorsiening te maak, bevat subart (2) 'n langerige lys uitsonderings op die verbodsbepalings in subart (1). Die Wetgewer se spesifieke oogmerk met art 226 was dus om sekere bepaalde vorms van geldelike bystand te verbied onderhewig aan bepaalde uitsonderings. Met die een hand verbied hy; met die ander hand veroorloof hy. Daar was dus nie 'n eenvoudige of ongekwalifiseerde oogmerk wat as toetssteen by die uitleg van die artikel gebruik kan word nie.”¹¹⁹

The example and conclusion of Botha JA certainly make sense when one considers that the object of the legislature was to protect the funds of the company from abuse by the directors of the holding company. In the *Bevray Investments* case the lending company was a wholly owned subsidiary of the holding company which, to a certain extent, negates the argument that the minority shareholders of the lending company should be protected from abuse by the majority shareholders since there are no minority shareholders. Creditors of the subsidiary company are, however, still exposed to abuse.

Should the provisions of section 226 be contravened the directors or officers of the company who authorised, permitted or who were party to the making of the prohibited loan or the provision of a prohibited security are liable to indemnify the company and any other person who had no actual knowledge of the contravention against any loss directly resulting from the invalidity of the loan or security and are also be guilty of an offence.¹²⁰

¹¹⁹ 623E-J. The argument of the majority is that the prohibition is not absolute and that there are exceptions which in the case at hand allowed the transaction.

¹²⁰ S 226(4)(b).

The section also provides that “director or officer” in the context includes any director or officer of the holding company, where the subsidiary is the lending company.¹²¹

On the one hand the new Companies Act simplifies the provision of financial assistance to directors of the company or to directors within the group of companies¹²² but on the other hand also complicates the provision of financial assistance with the introduction of the terms “related” and “inter-related”. Financial assistance to certain directors, who were prohibited under the 1973 Act from receiving such assistance, is no longer prohibited.¹²³ Should the company wish to provide financial assistance to a director of the company, or to a director of a related or inter-related company or to a person who is related to such director, the company has to satisfy the same requirements that apply where the company provides financial assistance to a company within the group or which is inter-related to the lending company.¹²⁴ All the requirements and consequences in respect of financial assistance within the group¹²⁵ apply *mutatis mutandis* to the financial assistance by a company to certain designated persons.¹²⁶

5.3.6 The concept of solvency and liquidity

The solvency and liquidity provisions of the new Companies Act are the first in South African companies legislation to deal specifically with groups of companies.¹²⁷ The solvency and liquidity test, which is now a prerequisite for certain company transactions, is a major departure from the original version of the 1973 Act where the philosophy was the maintenance of capital for the protection of creditors. That philosophy was, however, gradually eradicated over the last ten years when the legislature has allowed the buyback of shares by a company,¹²⁸ a subsidiary company being able to hold and acquire shares in

¹²¹ S 226(5) read with s 226(4).

¹²² S 45(2).

¹²³ S 227 of the 1973 Act also prohibited “golden handshakes” or payments for loss of office to directors subject to certain exceptions. The new Companies Act does not contain a similar provision but s 45(2) is conceivably broad enough to cover this situation.

¹²⁴ See para 5.3.2 above.

¹²⁵ Para 5.3.2 above.

¹²⁶ S 45(2) read with s 45(3)-(7).

¹²⁷ S 4.

¹²⁸ S 85 – 89 of the 1973 Companies Act.

its holding company,¹²⁹ and a company now being able to provide financial assistance for the acquisition of its shares subject to solvency and liquidity requirements.¹³⁰

The new Companies Act provides that the determination of whether a company satisfies the solvency and liquidity test involves the following. If the aggregate assets of the company, if it is a member of a group of companies, are equal to, or exceed the aggregate liabilities of the company, then the company is solvent.¹³¹ This provision is a radical departure from the provisions in the 1973 Act with respect to solvency and liquidity. The definition of “aggregate assets” and “aggregate liabilities” is not entirely clear but it could mean that a person applying the test should take into account all the assets and liabilities of the companies within the group to determine whether the solvency and liquidity test has been satisfied. However, the draft company regulations provide that

- (a) “Whenever the “aggregate assets of a company”, and the “aggregate liabilities of a company”, within a group of companies are required to be evaluated in terms of section 4 (1)(a) the evaluation must consider whether—
- (b) the assets of the relevant company equal or exceed its liabilities; and
- (c) the assets of each subsidiary of the relevant company equal or exceed that subsidiary’s liabilities.”¹³²

The wording of the regulation brings slightly more certainty. But there could still be uncertainty. For example, assume that a wholly-owned subsidiary holds shares in the holding company. Would this shareholding be taken into account to determine the value of the assets of the company? What if the holding company declared dividends to its

¹²⁹ S 89 read with s 39 of the 1973 Companies Act.

¹³⁰ S 9 of the Corporations Amendment Act 24 of 2006 inserting s 38(2A) into the 1973 Companies Act.

¹³¹ S 4(1) provides: “For any purpose of this Act, a company satisfies the solvency and liquidity test at a particular time if, considering all reasonably foreseeable financial circumstances of the company at that time—
(a) the assets of the company or, if the company is a member of a group of companies, the aggregate assets of the company, as fairly valued, equal or exceed the liabilities of the company or, if the company is a member of a group of companies, the aggregate liabilities of the company, as fairly valued; and
(b) it appears that the company will be able to pay its debts as they become due in the ordinary course of business for a period of—
(i) 12 months after the date on which the test is considered; or
(ii) in the case of a distribution contemplated in paragraph (a) of the definition of ‘distribution’ in section 1, 12 months following that distribution.”

¹³² Draft regulation 33.

shareholders? Would the dividend declared to the subsidiary be an asset of the subsidiary which should be taken into account?¹³³

The new Companies Act further provides that to determine whether a company complies with the solvency and liquidity requirements, the financial information of the company upon which the assessment of the company's financial position is made, should be based on the accounting records and financial statements which satisfy the provisions of the new Act.¹³⁴

5.3.7 Fiduciary duties within company groups

The new Companies Act also provides for the extension of the fiduciary duties of directors to duties to the subsidiary company. The new Companies Act provides that a director of a company should not use his position or any information which he obtains while in his office as a director to knowingly cause harm to the subsidiary company of the company of which he is a director.¹³⁵ The fiduciary duties of a director in respect of a subsidiary company are, however, not extended to all his fiduciary duties.¹³⁶ The effect of the provisions in the new Companies Act regarding the fiduciary duties of directors in the context of company groups is uncertain, especially where there is a conflict between the interests of the holding company and those of the subsidiary company. The effect of these provisions on the common-law position is also uncertain.¹³⁷

5.3.8 Fundamental transactions

The provisions in the new Companies Act dealing with fundamental transactions are also extended to apply to groups of companies.¹³⁸ The chapter on fundamental transactions deals firstly with proposals by the board of directors to dispose of all of or the greater part of the company's assets or undertaking.¹³⁹ These provisions, outlined below, do not apply

¹³³ See the *Unisec Group Ltd v Sage Holdings Ltd* para 5.2 above.

¹³⁴ S 4(2) read with ss 28 and 29 respectively. See also para 5.3.1 above.

¹³⁵ S 76(2)(a)(ii).

¹³⁶ S 76(3).

¹³⁷ See para 1.4.1(ii) above for a brief discussion of the common-law duties of directors within a group of companies.

¹³⁸ Chapter 5 of the new Companies Act.

¹³⁹ S 112.

to transactions where the disposal is between a wholly-owned subsidiary and its holding company¹⁴⁰ or between or among two or more wholly-owned subsidiaries of the same holding company,¹⁴¹ or between or among a wholly-owned subsidiary on the one hand and its holding company and one or more wholly-owned subsidiaries of that holding company on the other hand.¹⁴²

In terms of the new Companies Act a company may only dispose of all or the greater part of its assets or its undertaking if it has adopted a special resolution¹⁴³ and complies with all the other requirements of section 115. The implication is obvious within the context of company groups. Unless the parties fall under the exemptions referred to above, a disposal between a subsidiary company and its holding company, a holding company and its subsidiary and two co-subsiaries will have to comply with the provisions of section 112 of the new Companies Act read with section 115.

Section 115 provides that a special resolution by the shareholders of the disposing company is required and, if the company is a subsidiary, the shareholders of the holding company must also adopt a special resolution if the holding company is a company¹⁴⁴ or an external company;¹⁴⁵ if having regard to the consolidated financial statements of the holding company the disposal by the subsidiary company substantially has the effect that the assets or the greater part of the assets or undertaking of the holding company is being disposed of.¹⁴⁶ The fact that the shareholders of the holding company also have to vote is to be welcomed since by that means minority shareholders of the holding company may prevent any abuse in the vote by the shareholders of the subsidiary company¹⁴⁷ or at the very least prevent the shareholders of the subsidiary alone deciding on such a crucial matter, since the value of the subsidiary, which is an asset of the holding company, could be devalued by the sale of its assets or its undertaking.

¹⁴⁰ S 112(1)(b).

¹⁴¹ S 112(1)(c)(i).

¹⁴² S 112(1)(c)(ii).

¹⁴³ S 112(2)(a) read with section 115.

¹⁴⁴ See para 5.2, 146-147 above.

¹⁴⁵ S 115(2)(b)(i).

¹⁴⁶ S 115(2)(b)(iii).

¹⁴⁷ See also s 115(8) regarding the appraisal rights of dissenting shareholders in terms of s 164.

The next provision, which will be briefly considered, deals with amalgamations or mergers.¹⁴⁸ The relevant section provides, among other possibilities, that two profit companies like a holding company and its subsidiary company may amalgamate or merge if upon such amalgamation or merger the amalgamated or merged entity satisfies the solvency and liquidity test.¹⁴⁹ The companies may therefore be insolvent prior to their amalgamation or merger but after the implementation of the merger or amalgamation the merged or amalgamated entity has to comply with the solvency and liquidity test.

The new Companies Act also makes provision for takeovers and regulations in respect of takeovers where subsidiary companies may play a role.¹⁵⁰ The new Companies Act also deals with compulsory acquisitions and squeeze outs¹⁵¹ and comparable and partial offers.¹⁵² For the purposes of this dissertation, an investigation of these provisions is not, however, warranted. It suffices to say that the holding of shares by a subsidiary of an offeror company plays a role in the determination of certain thresholds.¹⁵³

5.3.9 Statutory piercing of the corporate veil

The new Companies Act provides for statutory piercing of the corporate veil.¹⁵⁴ The test which is set is that an “unconscionable abuse” of separate juristic personality must have occurred. This test seems narrower than the common-law test in the *Cape Pacific* case.¹⁵⁵

¹⁴⁸ S 113. S 1 provides that “amalgamation or merger” means a transaction, or series of transactions, pursuant to an agreement between two or more companies, resulting in—

(a) the formation of one or more new companies, which together hold all of the assets and liabilities that were held by any of the amalgamating or merging companies immediately before the implementation of the agreement, and the dissolution of each of the amalgamating or merging companies; or

(b) the survival of at least one of the amalgamating or merging companies, with or without the formation of one or more new companies, and the vesting in the surviving company or companies, together with such new companies, of all of the assets and liabilities that were held by any of the amalgamating or merging companies immediately before the implementation of the agreement.”

¹⁴⁹ S 113(1)

¹⁵⁰ Chapter 5, Parts B and C.

¹⁵¹ See s 124(1) and (4) for the meaning of these terms. See also the German provisions regarding squeeze outs within groups, para 4.4.2.5 above.

¹⁵² S 125.

¹⁵³ See for example s 124(1).

¹⁵⁴ S 163(4). See also s 65 of the Close Corporations Act 69 of 1984 for a similar provision. The provision in the Close Corporations Act, however, refers to the “gross abuse” of the separate juristic personality of the close corporation.

¹⁵⁵ See para 2.7.2 above.

This provision does not however repeal the common-law but provides an alternative remedy. In the light of the broad common-law test the narrower statutory test will fall within the common-law test. The statutory test would, had it not been for the common-law test, have made it more difficult to pierce the corporate veil. For the purposes of this dissertation regarding the liability of the holding company for the obligations of its subsidiary, this statutory test would have made potential liability more difficult to establish instead of alleviating the evidentiary burden on an external creditor of the subsidiary company.

5.3.10 Miscellaneous matters

The new Companies Act also provides that a company may not pay a fine of its own director or that of a related company who has been convicted of an offence in terms of any national legislation.¹⁵⁶ This excludes administrative fines and presumably fines for traffic violations.

There are also other provisions in the new Companies Act which refer to subsidiary companies. For example, the new Companies Act provides that an offer of securities to certain financial services providers and financial institutions shall not be regarded as an offer to the public. The same applies to an offer to their wholly owned subsidiaries.¹⁵⁷

5.3.11 Summary

In summation it can be said that the new Companies Act fundamentally changes the landscape in respect of groups of companies. The provisions of the 1973 Act have been improved in respect of loans within groups and loans to directors within groups.¹⁵⁸ The abolition of the membership requirement to qualify as a holding company is also to be welcomed and the easy circumvention of the definition under the 1973 Act has now been addressed. It is however a pity that the definition of a wholly-owned subsidiary has been badly drafted.¹⁵⁹ Furthermore it is not clear how a director's duty to the company of

¹⁵⁶ S 78(3).

¹⁵⁷ S 96(1)(a)(iv)-(vi).

¹⁵⁸ See paras 5.3.2 and 5.3.5 above.

¹⁵⁹ See para 5.2 above.

which he is a director and to its subsidiary company will work where there is conflict between the interests of the holding company and the subsidiary company.¹⁶⁰

The solvency and liquidity requirement can potentially bring about a big change in the way that the funds of subsidiary companies are utilised. Loans and other forms of financial assistance for other group members will be more difficult. The problems highlighted by Botha JA in the *Bevray*¹⁶¹ case may therefore have been partially addressed. However no provision is made to keep the subsidiary economically viable, which means that the holding company will still, subject to the solvency and liquidity tests, be able to withdraw funds from the subsidiary company as dividends and not allow it to grow independently. There is also no specific provision, despite the provision regarding the limited fiduciary duty of the directors of the holding company towards its subsidiary,¹⁶² to prevent a holding company from forcing its subsidiary not to take a corporate opportunity, but to divert it to another group member. Although groups and possible abuse within groups are generally better regulated in the new Companies Act than in the 1973 Act, there is probably still room for improvement, especially in respect of the insolvency of a subsidiary company.¹⁶³

5.4 The Competition Act

The Competition Act¹⁶⁴ is a relatively new piece of legislation and the jurisprudence in this area of the law is still in its infancy. For the purposes of company groups, however, this Act is extremely relevant.

Section 4 of the Competition Act provides that restrictive horizontal practices are prohibited. Section 4 provides that:

“(1) An agreement between, or concerted practice by, firms, or a decision by an association of firms, is prohibited if it is between parties in a horizontal relationship and if-

¹⁶⁰ See para 5.3.7 read with para 1.4.1(ii) above.

¹⁶¹ See 162, n813 above.

¹⁶² S 76(2)(a)(ii), see para 5.3.7 above.

¹⁶³ See chapter 7 below.

¹⁶⁴ Act 89 of 1998.

- (a) it has the effect of substantially preventing, or lessening, competition in a market, unless a party to the agreement, concerted practice, or decision can prove that any technological, efficiency or other pro-competitive gain resulting from it outweighs that effect; or
- (b) it involves any of the following restrictive horizontal practices:
 - (i) directly or indirectly fixing a purchase or selling price or any other trading condition;
 - (ii) dividing markets by allocating customers, suppliers, territories, or specific types of goods or services; or
 - (iii) collusive tendering.
- (2) An agreement to engage in a restrictive horizontal practice referred to in subsection (1) (b) is presumed to exist between two or more firms if-
 - (a) any one of those firms owns a significant interest in the other, or they have at least one director or substantial shareholder in common; and
 - (b) any combination of those firms engages in that restrictive horizontal practice.
- (3) A presumption contemplated in subsection (2) may be rebutted if a firm, director or shareholder concerned establishes that a reasonable basis exists to conclude that the practice referred to in subsection (1) (b) was a normal commercial response to conditions prevailing in that market.
- (4) For purposes of subsections (2) and (3), 'director' means-
 - (a) a director of a company as defined in the Companies Act, 1973 (Act 61 of 1973);
 - (b) a member of a close corporation as defined in the Close Corporations Act, 1984 (Act 69 of 1984);
 - (c) a trustee of a trust; or
 - (d) a person holding an equivalent position in a firm.
- (5) The provisions of subsection (1) do not apply to an agreement between, or concerted practice engaged in by,-
 - (a) a company, its wholly-owned subsidiary as contemplated in section 1 (5) of the Companies Act, 1973, a wholly owned subsidiary of that subsidiary or any combination of them; or
 - (b) the constituent firms within a single economic entity similar in structure to those referred to in paragraph (a).”

A restrictive horizontal practice is defined in section 4(1)(b). The word “firm” is not comprehensively defined in the Act and the definitions section of the Act merely

describes “firm” as including a person, a partnership or a trust.¹⁶⁵ It is important, however, to note that that section 4(1) will not apply “to an agreement between, or concerted practice engaged in by (a) a company, its wholly-owned subsidiary, a wholly-owned subsidiary of that subsidiary or any combination of them; or (b) the constituent firms within a single economic entity similar in structure to those referred to in (a).”¹⁶⁶

Section 4 of the Competition Act is relevant in the context of agreements that are concluded between firms and associations of firms, and concerted practices of firms and associations of firms.¹⁶⁷ This begs the question as to what constitutes a “firm” in the context of competition law. According to Sutherland,¹⁶⁸ any type of entity could be a firm if it is a separate economic unit. Furthermore an entity should only be seen as a firm if it is engaged in economic activity.

The principle that a group of companies can in certain circumstances be accepted as a single economic unit has been accepted in European competition law, and in anti-trust law of the United States of America in the realm of restrictive horizontal practices.¹⁶⁹ According to Sutherland¹⁷⁰ the decisions of the courts in the United States, prior to *Copperweld Corp v Independence Tube Corp*,¹⁷¹ in general terms, were based on the premise that conspiracies between intra-enterprise companies were possible. The Supreme Court in *Copperweld* held that a conspiracy is not possible between a holding company and its wholly-owned subsidiary. The Competition Tribunal in South Africa in *Bulmer SA (Pty) Ltd v Distillers Corporation SA Ltd*¹⁷² quoted the following relevant passage from *Copperweld*:

“A parent and its wholly owned subsidiary have a complete unity of interest. Their objectives are common, not disparate; their general corporate actions are guided or determined not by two

¹⁶⁵ See s 1(2) “firm”.

¹⁶⁶ S 4(5).

¹⁶⁷ S 4(1).

¹⁶⁸ Sutherland & Kemp *Competition Law of South Africa* (2005) Service Issue 6 5-20 with reference to Waelbroeck & Frignani *European Competition Law* (1999) 33.

¹⁶⁹ See *Viho Europe BV v Commission of the European Communities* 1996 ECR I 5457; *Copperweld Corp v Independent Tube Corp* 467 US 752 (1984) at 771; *Bulmer SA (Pty) Ltd v Distillers Corporation (SA) Ltd (1)* [2001-2002] CPLR 448 (CT) para 5.7.4 below.

¹⁷⁰ Sutherland & Kemp *Competition Law* 5-22.

¹⁷¹ *Copperweld Corp v Independence Tube Corp* 467 US 752 (1984).

¹⁷² *Bulmer SA (Pty) Ltd v Distillers Corporation SA Ltd* [2001-2002] CPLR 448 (CT).

separate consciousnesses but by one. They are not unlike a multiple team of horses drawing a vehicle under the control of a single driver. [...] If a parent and a wholly owned subsidiary do agree to a course of action, there is no sudden joining of economic resources that had previously served different interests [...].”¹⁷³

It is interesting to note that the court holds that a company and its wholly-owned subsidiary have the same objectives and that the course of the two entities is guided by one consciousness. Should the subsidiary company fail to act in the best interests of the holding company the holding company will exercise the control that it has over the subsidiary.¹⁷⁴

According to Sutherland the first part of section 4(5)(a) of the South African Competition Act reflects this approach, but the approach in *Copperweld* also raises a few issues that need to be addressed.¹⁷⁵ Sutherland asks whether the shareholding in a subsidiary should be decisive to determine whether section 4 of the South African Competition Act should apply. He argues further that the European approach is preferable. In terms of that approach the focus is on whether the subsidiary is autonomous to determine its own direction or whether it forms part of a single economic unit. The fact that the subsidiary is a wholly-owned subsidiary is not decisive either way. Sutherland furthermore argues that it would be preferable to work with a presumption that wholly-owned subsidiaries and their holding companies form single economic units.¹⁷⁶

According to Sutherland it is conceivable that the required collusion for purposes of section 4 of the Act may sometimes not be present, even in cases where the subsidiary company is not wholly owned. He refers to a number of cases in the United States of America where the *Copperweld* principle has been extended to situations where the particular companies were not wholly-owned companies. The South African Competition Act provides that section 4 of the Act does not apply where constituent firms are “within a single economic entity similar in structure” to those between a company and its wholly-

¹⁷³ *Copperweld* 771.

¹⁷⁴ *Copperweld* 771-772.

¹⁷⁵ Sutherland & Kemp *Competition Law* 5-22.

¹⁷⁶ Sutherland & Kemp *Competition Law* 5-22.

owned subsidiary.¹⁷⁷ According to Sutherland the Competition Act would appear to require two conditions to be met. First of all there must be a single economic entity and secondly the entity must have a similar structure to one that exists between a holding company and its wholly-owned subsidiary company or between wholly-owned subsidiary companies.¹⁷⁸

In the arena of competition law Sutherland is of the opinion¹⁷⁹ that there are several considerations to take into account when asking whether a single economic entity exists.¹⁸⁰ The mere fact that a number of separate companies may have the same mutual interests does not necessarily imply that those companies would constitute a single economic entity. For example a cartel could not possibly be deemed to be a single economic entity although the members of the cartel have mutual interests. The question should rather be whether the relevant companies acted with a unified purpose in mind, as opposed to mutual and overlapping self interest.

Before the European competition authorities accept that a holding company and its subsidiary form a single economic unit, they require that a subsidiary company does not unilaterally embark on its own direction in the market but takes note of, and carries out, the instructions of the holding company, or that companies must be unable to compete for them to form a single economic unit.¹⁸¹

Sutherland argues that the actual integration of the business activities, management and the flow of funds of the relevant companies should be important factors which should be taken into account to decide whether a single economic entity exists or not. The shareholding of the holding company should, however, not be conclusive.¹⁸²

¹⁷⁷ S 4(5)(b).

¹⁷⁸ Sutherland & Kemp *Competition Law* 5-23.

¹⁷⁹ With reference to Owen T Prell “*Copperweld Corp v Independence Tube Corp*” 1986 *Cornell LR* 1151 1174.

¹⁸⁰ Sutherland & Kemp *Competition Law* 5-23.

¹⁸¹ Sutherland & Kemp *Competition Law* with reference to *Ahmed Saeed v ZBW* 66/86 paras 35-36; *Bodson v Pompes Funebres des Region Liberees* 30/87; Michel Waelbroeck & Aldo Frignani *European Competition Law* (1999) 38-39; *ICI v Commission* 48/69 par 133; *Viho Europe BV v Commission* T-102/92 par 47.

¹⁸² Sutherland & Kemp *Competition Law* with reference to *Freeman v San Diego Association of Realtors* 322 F 3d 1133 (9th Cir 2003) 1148.

It is submitted that Sutherland is correct in stating that section 4(5)(b) of the Competition Act has been badly drafted and is problematic. Only one of the two requirements in section 4(5)(b) is important, namely the requirement that there must be a single economic unit present. Where the same companies together are in control of other companies and the controlling companies and the controlled companies function as a single economic unit, the collusion required for conduct to amount to a prohibited restrictive horizontal practice under section 4 of the Competition Act is not possible.

5.5 Company groups and tax law

The Income Tax Act¹⁸³ (the ITA) makes provision for the concept of a group of companies. It defines a group of companies as:

“two or more companies in which one company (‘the controlling group company’) directly or indirectly holds shares in at least one other company (‘the controlled group company’), to the extent that at least 70% of the equity shares of each controlled group of companies are directly held by the controlling group company, one or more other controlled group companies or any combination thereof; and the controlling company directly holds at least 70% in the equity shares in at least one controlled group company.”¹⁸⁴

This definition sets a very high threshold before companies will be in a group relationship compared to the definitions of a holding and subsidiary company in the new Companies Act.¹⁸⁵ Should a company therefore directly hold less than 70% of the equity shares in at least one other company, it would not qualify as a “controlling group company” to constitute a company group in terms of the ITA.

Another term that appears in the definitions section of the ITA is that of a “connected person”. The term is defined in relation to natural persons, trusts, partnerships and companies. In relation to companies the term is defined to include “any other company that would be part of the same group of companies as that company as if the expression

¹⁸³ 58 of 1962.

¹⁸⁴ S 1 ITA.

¹⁸⁵ See para 5.2, 146 above.

‘at least 70 per cent’ in paragraphs (a) and (b) of the definition ‘group of companies’ in this section were replaced by the expression ‘more than 50’ per cent’.¹⁸⁶

There are a number of other references to company groups in the ITA which will be discussed to the extent that they are relevant to this dissertation. First of all any gain made by a employee from a disposal of any equity shares which he obtained in terms of a broad-based employee share plan has to be included in the income of that person for the year of assessment, if that disposal occurred within five years of the grant of the equity shares.¹⁸⁷ However, this provision will not be applicable should there be a subdivision, consolidation, conversion or restructuring of the equity share capital of the employer or any employer in the same group of companies as the employer and the person disposes of his equity shares in exchange for equity shares in the employer or any other company in the group of companies of the employer.¹⁸⁸

The ITA provides that to determine the taxable income of a person, who carries on a trade, deductions will be allowed for “expenditure and losses actually incurred in the production of income, provided such expenditure and losses are not of a capital nature.”¹⁸⁹ This does not, however, entitle a holding company to deduct losses made by its subsidiary company from its income.¹⁹⁰ In *ITC 1684*¹⁹¹ a subsidiary produced certain components in the motor vehicle industry for export. Its holding company procured orders for these components. The subsidiary entered into a commission agreement with its holding company in terms of which the subsidiary would pay the holding company commission based on the orders which the holding company procured for the subsidiary company. In the relevant tax year the subsidiary deducted the commission which it paid to its holding company in terms of the ITA.¹⁹² The Commissioner of Inland Revenue argued that the commission was of a capital nature and therefore not tax deductible. The

¹⁸⁶ S 1 ITA “connected person” (d)(i). See s 1 (d)(v) and (vA) of the ITA for further definitions of what “connected person” means in relation to companies.

¹⁸⁷ S 8B(1) ITA.

¹⁸⁸ S 8B(1)(a) read with s 8B(2) ITA.

¹⁸⁹ S 11(a) ITA.

¹⁹⁰ *ITC 278* (1933) 7 SATC 246 (U).

¹⁹¹ 62 SATC 413.

¹⁹² S 11(a) read with s 23(g) ITA.

court, however, held that the commission paid was of a revenue nature and therefore deductible from the subsidiary's income.

The supply and acquisition of services in terms of international agreements¹⁹³ are also relevant to connected persons. In terms of the ITA, if there is an international transaction for the supply or acquisition of services or goods between connected persons the Commissioner of Inland Revenue may adjust the value of the performance in terms of the transaction to reflect the arm's length price of the goods or services if the price of the transaction is more or less than it would have been were the transaction concluded between two independent parties at arm's length.¹⁹⁴ The purpose of this section is clearly to avoid abuse between parties who are not at arm's length. The section is therefore not exclusively aimed at company groups but applies to any connected parties.

Part III of the ITA provides for special rules relating to company formations,¹⁹⁵ share-for-share transactions,¹⁹⁶ merger transactions,¹⁹⁷ intra-group transactions,¹⁹⁸ unbundling transactions¹⁹⁹ and liquidation transactions.²⁰⁰

A share-for-share transaction is defined²⁰¹ in the ITA. In terms of a proviso to this definition, the provision does not apply to a disposal by a person of target shares²⁰² to an acquiring company²⁰³ where the person and the target company²⁰⁴ form part of the same group of companies immediately before and after the disposal, if the parties so choose. The section on merger transactions also does not apply to the disposal of assets between parties within the same group of companies should the parties so choose.²⁰⁵

¹⁹³ S 31(1)(a) ITA.

¹⁹⁴ S 31(2) ITA.

¹⁹⁵ S 42 ITA.

¹⁹⁶ S 43 ITA.

¹⁹⁷ S 44 ITA.

¹⁹⁸ S 45 ITA.

¹⁹⁹ S 46 ITA.

²⁰⁰ S 47 ITA.

²⁰¹ S 43 ITA.

²⁰² S 43(1)(a) ITA.

²⁰³ S 43(1)(a) ITA.

²⁰⁴ S 43(1)(a) ITA.

²⁰⁵ S 44(1) ITA proviso.

The rules in respect of intra-group transactions are of particular relevance.²⁰⁶ An intra-group transaction is defined as a transaction:

- “(a) in terms of which any asset is disposed of by one company ([...] the transferor company) to another company which is resident ([...] the transferee company) and both parties form part of the same group of companies as at the end of the day of that transaction;
- (b) as a result of which that transferee company acquires that asset from that transferor company as a capital asset, where that transferor company holds it as a capital asset; or as trading stock, where that transferor company holds it as trading stock; and
- (c) in respect of which that transferor company and that transferee company have jointly elected that this section applies.”²⁰⁷

If an intra-group transaction takes place, and both parties elect that section 45 of the ITA must apply, the parties to the transaction would qualify for rollover relief, i.e. they can carry over their tax liabilities from the tax year in which the transaction took place.²⁰⁸ If a holding company therefore disposes of a capital asset to its subsidiary, it is deemed that the disposal took place at base cost. This means that the holding company will not realise a capital gain or incur a capital loss in respect of the disposed asset.²⁰⁹ According to De Koker certain circumstances in section 45 would lead to the holding company and subsidiary company (in the above example) effectively being deemed to be one entity in determining any capital gain or capital loss by the holding company on the disposal of the asset,²¹⁰ for example the date that the capital asset was acquired by the holding company in the above example and the amount and date that it incurred any allowable base cost expenditure²¹¹ in respect of the asset.²¹²

²⁰⁶ S 45 ITA.

²⁰⁷ S 45(1) ITA.

²⁰⁸ De Koker *Silke on South African Income Tax* Memorial edition Volume III (2006) service 34 para 24.154F 24-211.

²⁰⁹ De Koker *Silke* 24-212.

²¹⁰ De Koker *Silke* 24-212.

²¹¹ See paragraph 20 of schedule 8 ITA.

²¹² De Koker *Silke* 24-212.

The sections dealing with unbundling transactions and transactions in respect of liquidation and deregistration of a company also regulates those situations where a group of companies is present.²¹³

Other provisions in the ITA relating to groups include: a provision in respect of the exemption from secondary tax on companies in terms of which any dividend that is declared by a company to a shareholder, which is a company that forms part of the same group of companies as the company that declares the dividend, is exempt from secondary tax on companies;²¹⁴ a section that allows for the deduction of the costs of providing a learnership to an employee by an employer or any company which forms part of the same group of companies as the employer who employs the learner and provides the learnership agreement;²¹⁵ a section which exempts a company from payment of donations tax if the donation is from one company to another company which is resident in South Africa and a member of the same group of companies as the donor company,²¹⁶ and payments between connected persons where the incurring or accrual of interest is relevant.²¹⁷ There is also a provision that deems certain distributions to be dividends.²¹⁸ However, any amount which is distributed between companies in the same group would be exempt from secondary tax on companies.²¹⁹

The eighth schedule to the ITA regulates the determination of taxable capital gains²²⁰ and assessed capital losses.²²¹ If a person disposes of shares within two years of acquiring them, he must ignore any capital loss due to the disposal to the extent of any extraordinary dividends²²² which accrued to that person or which he received within that two-year period in respect of that share.²²³ This provision, however, does not apply where

²¹³ Ss 46 and 47 ITA.

²¹⁴ S 64B(5)(f) ITA.

²¹⁵ S 12H(1) ITA.

²¹⁶ S 56(1)(r) ITA.

²¹⁷ S 24J ITA.

²¹⁸ S 64C ITA.

²¹⁹ S 64C(4)(k) read with s 64C(2) and s 64B ITA.

²²⁰ Para 3 of schedule 8 ITA.

²²¹ Paragraph 4 of schedule 8 ITA.

²²² Para 19(3)(c) of schedule 8 ITA defines an extraordinary dividend as: "so much of any dividends received or accrued [...] as exceed 15% of the proceeds received or accrued from the disposal of the share."

²²³ Para 19(1) of schedule 8 ITA.

dividends are declared by a company to a shareholder which forms part of the same group of companies as the company which declared the dividend and where the controlling company and the company declaring the dividend are both resident in South Africa.²²⁴

The Transfer Duty Act²²⁵ also provides for situations where a number of companies find themselves in a group situation. It provides that no duty is payable where an amalgamation transaction,²²⁶ an intra-group transaction²²⁷ or a liquidation distribution²²⁸ in respect of immovable property takes place in terms of the ITA.²²⁹

It is clear that tax legislation and competition law legislation are not blind to the reality of the economic reality of company groups and recognise that in many instances these groups form one entity. This reality is reflected in legislation and case law.

5.6 The Consumer Protection Act

The Consumer Protection Act²³⁰ was assented to on 24 April 2009 and will commence on 24 October 2010. One of the aims of this Act is to protect consumers from hazards and to provide them with the statutory means to claim damages for harm suffered from what may be broadly described as defective products.²³¹ The Act imposes strict liability on the producer, importer, distributor or retailer, among others, for supplying unsafe goods, a product failure, defect, or a hazard in goods if a consumer suffers harm due to one or more of these factors.²³² Companies within a vertically integrated group may therefore be exposed to damages claims from consumers. This could also open the door for abuse by a holding company. Assume that in a vertical economic chain, the group is organised as a

²²⁴ Para 19(2) of schedule 8 ITA. There are other provisions in schedule 8 of the ITA which also deals with company groups but will only be mentioned and not be discussed for the purposes of this dissertation. In this respect see paras 12(5), 39(1) and 39(2) and 64B ITA.

²²⁵ 40 of 1949.

²²⁶ See text above.

²²⁷ See text above.

²²⁸ See text above.

²²⁹ S 9(1)(l) of Act 40 of 1949.

²³⁰ 68 of 2008.

²³¹ Preamble to the Act.

²³² S 61.

producer, distributor and retailer and the group produces, distributes and then sells a defective product which causes harm to a consumer. The consumer has an election and may choose to proceed against the producer, the distributor or the retailer. If he is not aware of the existence of the group structure, he will conceivably institute legal action against the retailer. The retailer would in principle have a claim against the distributor. If the distributor is, however, its holding company or a fellow group member the chances are remote that the retailer will be indemnified. The Act may therefore stimulate the creation of subsidiaries and their use as undercapitalised retailers as the public interface of the group. Only the consumer who is aware of the group structure will search behind the retailer to determine who the distributor and producer were, which could impose a substantial evidentiary burden.

5.7 The judicial recognition of groups

The South African courts have had the opportunity to decide a number of cases that deal with company groups in a number of legal fields over the years. Reference will be made in this chapter to cases dealing with company groups in the fields of company law, criminal law, labour law, competition law, contract law, the law of delict and intellectual property law. The aim of this investigation is to establish whether the courts have been consistent in how they have dealt with groups in these various fields and if so, what the common thread is. Where there are discrepancies the reasons for that will be investigated. Cases dealing with company groups in the context of the law of insolvency will, however, be discussed in chapter 7.

5.7.1 Company law

One of the first cases where the concept of a company group was raised, even if only in passing, was *Robinson v Randfontein Estates Gold Mining Co Ltd*.²³³ The case dealt with the breach of fiduciary duty by Robinson who exercised control over the boards of the respondent as well as its subsidiaries through his nominee directors. Innes CJ said the following:

²³³ *Robinson v Randfontein Estates Gold Mining Co Ltd* 1921 AD 168.

“If a mandate was rightly inferred, then there is no need for further discussing the question of fiduciary relationship. But, even if the relationship between the defendant and the company could not be fitly described as one of agent and principal, I should still hold that it was fiduciary. *I had occasion in Hull v Turf Mines, Limited (1906, T.S p. 68), to remark upon the anomalous and undesirable positions which arise in the working of the group system. It is a system much in vogue in the Transvaal, and it exists in the present instance under the new regime as it did under the old. It involves the management and direction of the policy and affairs of the various companies by some controlling authority through nominee directors. Whether the control is exercised by a man who is himself a director or by someone outside makes little difference in principle. In either case the system is peculiarly liable to abuse. Unless the board is moulded to the will of the controlling authority the system cannot work. An independent set of directors would be fatal.*”²³⁴

Already in 1921 in the *Robinson* case the courts therefore recognised the potential of abuse which could take place within a group of companies.

5.7.2 Criminal law

The next noteworthy case where mention is made of a group of companies, is the criminal matter of *Rex v Milne and Erleigh*.²³⁵ Centlivres CJ said the following:

“In the first place the appellants relied upon the existence of a group of companies some of which had appointed Erleigh their managing director and all of which had allowed him wide powers in carrying on their affairs. It was contended that, apart from the actual existence of wide powers granted to Erleigh expressly or by acquiescence in their exercise, allowance must be made, in judging his state of mind, for the reasonable possibility that he believed he had powers more extensive than he actually had. The word 'group' has been used with many shades of meaning. The basic idea seems to be: An association of companies, created not by resolutions to associate but by the acts of individuals, and depending on the facts that they have a single secretary, generally itself a company, and are controlled as to the appointment of their directors, and therefore as to the administration of their affairs, by one or a few people. The persons who wield the controlling power are the only legal personae apart from the companies themselves. *There is no persona which is the group, and there are no interests involved except the interests of the companies and the interests of the controllers. This is not mere legal technicality. No doubt it may be convenient to talk of the interests of the group, but no one could seriously think of the group as having interests distinct from those of the companies and controllers.* The fact that in a group bargaining between companies may often be non-existent, because the controllers decide, does not support the idea of a single persona with single interests. *No business man would be deceived into thinking*

²³⁴ 196, my italics.

²³⁵ *Rex v Milne and Erleigh* 1951 1 SA 791 (A).

*that in a group there is, in effect, a pooling of assets and a right in the controllers to deal with assets belonging to the companies without regard to their respective interests. Those interests must be adjusted by the controllers as honest boards would agree to do if there were no group, i.e. on fair and reasonable lines, having regard to the circumstances of each transaction. Erleigh owed duties to the companies of which he was a director and not to any concept called the group, and he certainly knew that.*²³⁶

The Appellate Division therefore recognised the separate identities of the companies within the group structure, and that a director only has a fiduciary duty to the company of which he is a director.

5.7.3 Labour law

In the field of labour law the treatment by the courts and industrial councils, under the former labour law dispensation, of company groups has been interesting. In most, if not all of the cases that are discussed below, the question that the courts had to answer was who the employer of a dismissed employee was within the context of a group of companies.

In *The Media Workers Association of SA v Facts Investors Guide (Pty) Ltd*²³⁷ certain workers were dismissed due to a work stoppage which the respondents treated as a strike. The first respondent averred that it was not the employer but that the second respondent was the employer of the dismissed workers. It was common cause that the respondents were associated companies (without the court stating what the relationship between them was in a legal sense), which operated in an interrelated manner, in that both utilised the labour of the affected employees, conducted their business from the same premises and had the same managing director. The wages of the dismissed employees were also paid by the first respondent.

The case for the dismissed employees was based on the argument that the two companies operated as an indivisible unit. The argument was that the managing director of the two

²³⁶ 827E-828B, my italics.

²³⁷ *The Media Workers Association of SA & Others v Facts Investors Guide (Pty) Ltd & Another* 1986 7 ILJ 313 (IC).

companies operated the companies as one single entity and indiscriminately made use of one or the other in the operation of the businesses.

The court sidestepped having to deal with piercing of the corporate veil by holding that the first respondent was the employer of the applicants. According to the court, its decision did not strictly speaking amount to the piercing of the corporate veil but this is also qualified by the statement that it does take into account the “realities of the situation”²³⁸ on a *prima facie* basis. Interestingly enough the court felt compelled to refer to *DHN Food Distribution Ltd v London Borough of Tower Hamlets*²³⁹ without expanding on its relevance.

In *SA Allied Workers Union v Contract Installations (Pty) Ltd*²⁴⁰ the applicants were retrenched by their employer and sought a reinstatement order in terms of the provisions of the Labour Relations Act.²⁴¹ The question that the court had to decide on was whether the second respondent, which denied that it ever employed the applicants, could be joined with the first respondent in an order for reinstatement if the court held that the retrenchment of the applicants was unfair.

The first respondent issued income tax forms to the applicants as well as other documentation. The applicants, however, showed that the second respondent sent correspondence to their trade union, the first applicant, and that as far as the trade union was concerned the second respondent was the employer of the applicants. Importantly, however, the applicants contended that they did not really rely on the argument that the second respondent was the employer of the applicants, but rather on the argument that the first and second respondents were associated in a single business enterprise and that the main shareholder in the first respondent also held the largest interest in the second respondent which was a close corporation. The argument was therefore that:

“in mind and management the first and second respondents are one and the same.”²⁴²

²³⁸ 315.

²³⁹ See para 3.10 above for a discussion of this case.

²⁴⁰ *SA Allied Workers Union & Others v Contract Installations (Pty) Ltd & Another* 1988 9 ILJ 112 (IC).

²⁴¹ S 43 of the Labour Relations Act 28 of 1956.

²⁴² 114C-D.

The applicants, *inter alia*, argued that the position *in casu* was similar to that in *Media Workers Association of SA v Facts Investors Guide (Pty) Ltd*,²⁴³ in that the respondents were associated companies.

More importantly the applicants also argued that where several companies operate as a group they can be regarded as a single body²⁴⁴ and referred to the *DHN*²⁴⁵ case. The industrial council considered the statements of Lord Denning MR in the *DHN* case and stated that:

“Nor in this case should the two corporate persons concerned be treated separately so as to succeed on a technical point. Although in this case there is not a parent company and a subsidiary company, there is clearly, on the papers before the court, a position where a private company is in a hand-and-glove situation with a close corporation, the principal shareholder in the one being the holder of the major interest in the other.”²⁴⁶

The industrial council then held that the phrase of “in mind and management the first and second respondent are one and the same” was an apt description of the factual situation which *prima facie* appeared to have existed. The industrial council acknowledged that although in law the first respondent was the employer of the applicants, in equity the second respondent, as umbrella company of the group, should be held responsible with the first respondent for the unfair retrenchments. The industrial council then further stated:

“Equity requires, however, that in circumstances such as prevail in this case the applicants should not be denied a remedy because their employer has ceased business while the group continues to operate.”²⁴⁷

This certainly is a most radical statement for the industrial council to make without citing any authority except the *DHN*²⁴⁸ case and the *Media Workers*²⁴⁹ case and completely

²⁴³ Above.

²⁴⁴ 115G.

²⁴⁵ Para 3.10 above.

²⁴⁶ 115I-J.

²⁴⁷ 116B-C.

²⁴⁸ See para 3.10 above.

²⁴⁹ Above.

ignoring the *Salomon*²⁵⁰ case and basic company law principles of separate juristic personality and relying heavily on equity which, in any event, is dubious.

In *Paper, Printing, Wood and Allied Workers Union v Kaycraft (Pty) Ltd*²⁵¹ the industrial council again had to deal with the retrenchment of employees within the context of a group. The applicants sought a reinstatement order in terms of the former Labour Relations Act.²⁵² Kaycraft was the wholly-owned subsidiary of Sterns Diamond Organization Ltd. The applicants were employed by Kaycraft but argued in the alternative that they were also employees of Sterns because Kaycraft was the wholly-owned subsidiary of Sterns which was also the holding company of other companies in the group and as such the employees were employed by the group.

The applicants had a recognition agreement with both Sterns and Kaycraft and a retrenchment procedure was also included in the agreement. Sterns decided to close Kaycraft and to relocate it. Sterns, not Kaycraft, informed the applicants of the relocation. The applicants as mentioned above sought an order against both respondents. The respondents argued that the industrial council could not disregard the principles of company law, namely the separate juristic personality of the respondents and issue an order against both respondents.

The industrial council referred to Cilliers & Benade as to when the corporate veil can be lifted, as well as to the *DHN*²⁵³ case.

“Cilliers & Benade at 15-16 submit that various factors should be considered by a court before applying the economic entity approach:

- (a) If the necessary degree of control, which will always be a question of fact, is present. If for example the relationship between the companies in the group is that of a holding company and wholly-owned subsidiary it can be indicative of the necessary control. Control will in reality have to be exercised in such a manner that the subsidiary is completely subservient to the holding company.

²⁵⁰ Above.

²⁵¹ *Paper, Printing, Wood and Allied Workers Union & Others v Kaycraft (Pty) Ltd & Another* 1989 10 ILJ 272 (IC).

²⁵² S 43 of the Labour Relations Act 28 of 1956.

²⁵³ Para 3.10 above.

- (b) If as far as is relevant there is an 'utter identity and community of interest' between the holding and subsidiary company in the group.
- (c) If by the treatment of each holding company and subsidiary in isolation it would in law lead to an unjustifiable inequity.
- (d) If the rights of creditors and shareholders will be prejudiced by this construction, this construction should not be applied.”²⁵⁴

The industrial council also referred to the LLD dissertation of Botha²⁵⁵ where he discussed the economic entity approach:

“These constructions should be applied conservatively if at all. Their application can only be supported if the strict application of the principle of the separate legal personalities of the holding and subsidiary company will prevent the law being applied to the ascertained facts, or will result in an injustice or anomaly.”²⁵⁶

The industrial council also referred to the *Media Workers*²⁵⁷ and *Contract Installations*²⁵⁸ cases. The council then held that various factors indicated that it would be equitable to regard Sterns and Kaycraft as being jointly responsible for the retrenchments. Without referring to any other authority the council then held that Sterns and Kaycraft should be held responsible as a group for the consequences of an unfair retrenchment.

In *Boumat v Vaughan*²⁵⁹ the Labour Appeal Court had to decide who the employer of Vaughan was. Vaughan was employed as the managing director of Plumbware, a wholly owned subsidiary of Durity, which in turn was a wholly-owned subsidiary of Boumat Ltd. Boumat was the holding company of a number of companies, the Boumat group of companies. The appointment of Vaughan was on the letterhead of Boumat Ltd.

The court referred first of all to the definition of employer in the previous Labour Relations Act.²⁶⁰ “Employer” was defined as:

²⁵⁴ 283A-D.

²⁵⁵ Botha *Groups in South African Company Law* LLD dissertation, University of Pretoria 1981.

²⁵⁶ 283E.

²⁵⁷ Above.

²⁵⁸ Above.

²⁵⁹ *Boumat v Vaughan* 1992 13 ILJ 934 (LAC).

²⁶⁰ Act 28 of 1956.

“any person whomsoever who employs or provides work for any person and remunerates or expressly or tacitly undertakes to remunerate him or who, subject to subsection (3), permits any person whomsoever in any manner to assist him in the carrying on or conducting of his business; and "employ" and "employment" have corresponding meanings.”²⁶¹

On the facts it appeared that Boumat was the employer but the court also, interestingly, pointed out that it was conceivable that an employee could have more than one employer.²⁶²

In *Sage v Fourwinds Transport Co Ltd*²⁶³ the applicant held various positions within a group of companies. The question again concerned who the employer was at the time that the applicant was dismissed. Considering all the evidence the industrial council held the following:

“However, when read together, the totality of evidence would certainly lead one to a picture of not such a rigid line between the respective companies within the group. It may be rigid from a pure legal or accounting point of view, but from the point of view of employees, and even management, going about their daily business, I am not so certain that the distinction is as rigid as respondent would have me believe.”²⁶⁴

The decision in *Board of Executors Ltd v McCafferty*²⁶⁵ was the first decision in which the Labour Appeal Court thoroughly grappled with the question of the separate existence of the individual companies within a group of companies, although it eventually neatly sidestepped the question of piercing the corporate veil and the existence of a group as an employer.

Board of Executors Ltd (BOE Ltd) was incorporated in 1987 and at the relevant time owned all the shares in both Board of Executors 1838 (BOE 1838) and Board of Executors Merchant Bank Ltd (BOE MB).

²⁶¹ Section 1 of the Labour Relations Act 28 of 1956.

²⁶² 939J.

²⁶³ *Sage v Fourwinds Transport Co Ltd* 1994 15 ILJ 1149 (IC).

²⁶⁴ 1153E.

²⁶⁵ *Board of Executors Ltd v McCafferty* 1997 18 ILJ 949 (LAC).

When it was not a party to the proceedings BOE MB admitted that it employed and therefore dismissed the respondent. The Industrial Court, therefore, *mero motu* substituted BOE MB for BOE Ltd as a party to the dispute. Ultimately the question before the Labour Appeal Court was whether BOE Ltd was the employer of the respondent.

The court referred to the definition of employer in the Labour Relations Act²⁶⁶ and then delved into a number of cases to determine when an “employer” is in fact an employer. The court concluded that an employer is one who accepts the placement of the employee’s capacity to work at the disposal of the recipient.

On the facts it was clear that there was great confusion, not only for the respondent but also within the group, since letterheads of different companies within the group were often used in correspondence with the respondent who was employed by various companies within the group from time to time. BOE Ltd argued that although there was confusion as to who the employer was, the burden of proof was on the respondent to prove who his employer was.

The court referred in its judgment to *Cape Pacific Ltd v Lubner Controlling Investments (Pty) Ltd*,²⁶⁷ *Adams v Cape Industries plc*,²⁶⁸ *Salomon v A Salomon & Co Ltd*,²⁶⁹ and *Botha v Van Niekerk*.²⁷⁰ The court accepted the point of departure that it should give effect to the law which recognises the creation of subsidiary companies which have separate identities to the holding companies.²⁷¹ The court found that *in casu* there was neither any “unconscionable injustice”²⁷² nor the flexible approach which was taken according to the court in the *Cape Pacific* case. The court therefore held that there was no basis to go behind the separate identity of the companies within the BOE stable.

²⁶⁶ Above.

²⁶⁷ Para 2.7.2 above.

²⁶⁸ Para 6.1 below.

²⁶⁹ Para 2.4 above.

²⁷⁰ Para 2.7.2 above

²⁷¹ *Adams and Salomon*.

²⁷² As required in *Botha v Van Niekerk*.

The respondent argued that the BOE group was his employer. BOE MB was controlled by BOE Ltd through an executive committee which reported to BOE Ltd and this executive committee controlled the operational companies down to decisions of restructuring, retrenchments and dismissals.

According to the court this submission of the respondent came to more than mere piercing of the corporate veil. The court concluded as follows:

“This submission is more than piercing the corporate veil. It does exactly that which respondent's counsel disputed he ever attempted to do. It introduces more than the concept of a single economic entity comprising BOE 1838, BOE-MB and BOE Ltd all acting in concert regardless of their separate corporate personalities. This submission is tantamount to introducing a new and independent creature quite distinct from but comprising BOE 1838, BOE Ltd and BOE-MB. Truly a fourth dimension. There is, in my view, merit in the argument but it was not pleaded and no basis has been advanced why there should be a departure from the pleadings to such a radical extent.”²⁷³

On the facts the court eventually found that the respondent was initially employed by BOE 1838, then by BOE MB before his services were terminated by BOE Ltd. The court therefore concluded that on the facts the respondent had three employers. This could be seen as a very neat sidestepping of dealing with the submission that the BOE group was the employer of the respondent and concomitantly the question of piercing of the corporate veil.²⁷⁴

In *Vermeulen v Cabletec Electrical & Mechanical Supplies (Pty) Ltd*²⁷⁵ the court again had to deal with a retrenchment within a group. In this case the criterion for retrenchment was “last in first out” (LIFO). The applicant did not dispute the fairness thereof but how LIFO was applied. He alleged that LIFO should have been applied throughout the group and not in individual subsidiaries within the group. Had this been done he alleged that he

²⁷³ 966G-I

²⁷⁴ One wonders what would have happened if in law an employee could only have one employer. The Labour Appeal Court *in casu* at least referred to relevant authority in respect of the question of piercing of the corporate veil, even if it eventually was not necessary to decide that question. In *SA Agricultural Plantation & Allied Workers Union v H L Hall & Sons (Group Services) Ltd and Others* 1999 20 ILJ 399 (LC) the court again acknowledges that employees can have more than one employer especially in the context of a group of companies.

²⁷⁵ *Vermeulen v Cabletec Electrical & Mechanical Supplies (Pty) Ltd & Another* 1999 20 ILJ 2968 (LC)

would not had been retrenched. Where LIFO is applied throughout a group the process is known as bumping. The court held that bumping is a complex issue and that regard should be taken of relevant factors like how the subsidiary companies are connected and the extent to which they are managed as a single entity. On the facts there were indicators that there was a very close connection between the companies within the group. Ultimately the court held on the facts that the application of LIFO in this instance was fair.

In *Airlink Pilots Association SA v SA Airlines (Pty) Ltd*²⁷⁶ the labour court was prepared to pierce the corporate veil although it acknowledged that, in terms of the *Cape Pacific* case,²⁷⁷ it had no general discretion to simply disregard a company's separate legal personality whenever it felt it was just to do so. It justified its decision as follows:

“The commercial arrangements in the group are not under attack. There is no need for it. The abovementioned facts do however demonstrate that the first respondent controlled the second respondent to the extent that it was the sole decision maker, particularly with regard to the employment of pilots. It would appear that the re-employment requirement and the resultant avoidance, of amongst other terms and conditions, the pilots' seniority system, is not a decision which emanates from the second respondent but from the first respondent. It appears to be a device to change the terms and conditions of the employment relationship between the first respondent and the applicant.

The second respondent has also failed to explain how it adopted and considered the selection process. It did not demonstrate any factual independence of its decision, in sharp contrast with the decision taken by the first respondent.

In my view, the applicant has on a balance of probabilities shown that the decision regarding the new terms and conditions in relation to the Embraer Jets was that of the first respondent, and in that context, the commercial relationship between the first respondent and the second respondent should be disregarded.”²⁷⁸

What can be gleaned from the *Airlink* decision is that if there had been sufficient evidence that the first respondent abdicated its responsibilities to the second respondent, the court may have decided to give effect to the commercial reality behind the structure and pierced the corporate veil.

²⁷⁶ *Airlink Pilots Association SA v SA Airlines (Pty) Ltd & Another* 2001 22 ILJ 1359 (LC).

²⁷⁷ Above.

²⁷⁸ 1366E-J.

The labour law cases dealing with company groups show that the industrial councils and labour courts have been more willing to disregard the separate identity of the various companies within groups. This willingness seemed to be based more on equity than on legal principles. Furthermore the councils and courts have also escaped having to deal with the legal principles regarding piercing of the corporate veil by simply holding that an employee in appropriate cases has more than one employer. Only in the *BOE* and the *Airlink Pilots* cases were thorough discussions of the applicable legal principles and case law present. The lack of thorough discussion should not, however, result in the other cases being summarily discarded. At least the respective bodies were willing to recognise the reality of the factual situations which were present.

5.7.4 Competition law

As shown above, groups of companies are also extremely relevant in the field of competition law.²⁷⁹ In *Bulmer SA (Pty) Ltd v Distillers Corporation (SA) Ltd (1)*²⁸⁰ Distillers entered into a transaction by which it would acquire the business of Stellenbosch Farmers' Winery Group (Pty) Ltd. The question before the Competition Tribunal was whether this transaction constituted a merger in terms of the Competition Act.²⁸¹ If it was a merger in terms of the said Act the respondents were required to notify the Competition Commission of the transaction.

Initially the Competition Commission advised the respondents that the transaction did not constitute a merger. The applicant then applied to the Competition Tribunal for an order declaring that the transaction between Distillers and Stellenbosch Farmers' Winery (Pty) Ltd was a merger, and that the Competition Commission should have been notified of this in terms of the Competition Act.

The shareholding of the two respondents was crucial in this case. Important also was the history of the South African liquor industry. Prior to 1979, two separate companies, Oude

²⁷⁹ See para 5.4 above the discussion in respect of competition law legislation.

²⁸⁰ *Bulmer SA (Pty) Ltd v Distillers Corporation (SA) Ltd (1)* [2001-2002] CPLR 448 (CT).

²⁸¹ 89 of 1998.

Meester Group Limited (“OMG”) and Stellenbosch Farmers’ Winery (Pty) Ltd (“SFW”) competed. Other major players were SAB (in the beer market) and the Ko-operatiewe Wijnbouwers Vereniging van Zuid-Afrika Beperkt (“KWV”).

In 1979 Cape Wine and Distillers Limited (“CWD”) was formed. This occurred pursuant to an arrangement between SAB, SFW, OMG and KWV. In terms of the agreement SAB bought the Rembrandt Group’s beer interest in exchange for limiting its involvement in wine and spirits to its 30% investment holding in CWD. SFW and OMG also became wholly owned subsidiaries of CWD. CWD was listed on the Johannesburg Stock Exchange with the following shareholders: the Rembrandt Group held 30%; SAB held 30%; KWV held 30% and the public held the remaining 10%. The Rembrandt Group and the KWV then formed a jointly owned holding company, Rembrandt-KWV Investments Limited, in which their respective shareholdings in CWD were consolidated to a 60% shareholding. OMG’s interests were transferred to a new entity, Distillers Corporation in 1988 and CWD retained the business of SFW.

In terms of an agreement dated 20 September 2000 the respondents entered into a transaction in terms of which Distillers would acquire all the principal assets and liabilities of SFW. As mentioned above the Commission initially advised the respondents that the transaction was not a merger. It then changed its mind and advised that it was a merger, but subsequently, after consultations with the respondents, again advised that the transaction did not constitute a merger.²⁸²

The central question before the Tribunal was therefore whether this transaction between Distillers and SFW constituted a merger of which the Competition Commission should have been notified of in terms the Competition Act.²⁸³ The crux of the case of the respondents was that the transaction did not bring about an “effective” change in the control of SFW and Distillers and therefore was not a merger in terms of section 12 of the Competition Act.

²⁸² 453.

²⁸³ S 13 of the Act.

Sections 12(1) and 12(2) of the Competition Act state that:

- “(1) (a) For purposes of this Act, a merger occurs when one or more firms directly or indirectly acquire or establish direct or indirect control over the whole or part of the business of another firm.
- (b) A merger contemplated in paragraph (a) may be achieved in any manner, including through-
 - (i) purchase or lease of the shares, an interest or assets of the other firm in question; or
 - (ii) amalgamation or other combination with the other firm in question.
- (2) A person controls a firm if that person-
 - (a) beneficially owns more than one half of the issued share capital of the firm;
 - (b) is entitled to vote a majority of the votes that may be cast at a general meeting of the firm, or has the ability to control the voting of a majority of those votes, either directly or through a controlled entity of that person;
 - (c) is able to appoint or to veto the appointment of a majority of the directors of the firm;
 - (d) is a holding company, and the firm is a subsidiary of that company as contemplated in section 1 (3) (a) of the Companies Act, 1973 (Act 61 of 1973);
 - (e) [...];
 - (f) [...];
 - (g) has the ability to materially influence the policy of the firm in a manner comparable to a person who, in ordinary commercial practice, can exercise an element of control referred to in paragraphs (a) to (f).”

The argument of the applicants was that a person, Distillers, acquired direct control over the business of SFW by way of a purchase of the assets of SFW.

Distillers and SFW, however, urged the Tribunal to look at the substance and not the form of the transaction. They argued that the intention of the legislature was that notification should only take place when there were changes to “ultimate” or “effective” control. As a matter of form Distillers had assumed control over the business of SFW but the reality was that both Distillers and SFW had been controlled by the same three shareholders prior to the transaction and Distillers, now Distell, would still be controlled by these three shareholders and that therefore no change in effective control had taken place. The crux of the argument was that these two companies were located in the same economic family, and where a re-arrangement between a seller and a buyer within the family takes place there is no change in the effective control. The transaction would therefore fall outside the ambit of section 12 of the Competition Act.

The Tribunal referred to section 4(5)²⁸⁴ of the Competition Act and comparative jurisprudence to analyse the arguments of Distillers. The Tribunal referred to European Law where the doctrine of a single economic entity has emerged in case law in the context of whether article 85(1) of the European Community Treaty applied. Article 85(1) of the Treaty, now article 81(1), is the general prohibition against agreements constituting restrictive practices similar to sections 4 and 5 of the South African Competition Act. The courts in Europe had to decide whether agreements between undertakings that formed part of the same group could amount to restrictive practices. The courts held that they did not, provided that the subsidiary did not have any real autonomy in determining its line of conduct.²⁸⁵

The Tribunal also referred to the United States of America and to the doctrine of the intra-enterprise conspiracy which had been applied to conspiracies amongst commonly controlled companies. In 1984 the Supreme Court held that a parent and its wholly owned subsidiary must be treated as a single enterprise and were thus incapable of forming a conspiracy for the purposes of the section 1 of the Sherman Act.²⁸⁶

The Tribunal stated that the case law referred to and section 4(5) of the Competition Act suggested that at least for the purpose of restrictive practice adjudication, the concept of a single economic entity was well established. The arguments of the respondents therefore had merit. The Tribunal, however, cautioned against the use of the single enterprise argument, simply because it is a concept that has proven to be useful in limiting the boundaries of restrictive practices to intra-enterprise arrangements. This is an area of substantive law as opposed to merger notification which is an area of procedural law.²⁸⁷

“At this early stage of our jurisprudence we can say no more than that transactions within the ambit of section 4(5)(b) may be recognized as a single economic unit, for the purposes of section 12, but the provision must be interpreted strictly. The less something looks like a wholly owned parent subsidiary relationship the more cautious we need to be. To put it another way, the more

²⁸⁴ See para 5.4 above.

²⁸⁵ See *Viho Europe BV v Commission of the European Communities* 1996 ECR I 5457.

²⁸⁶ See para 2.2.4.1 above.

²⁸⁷ 463.

ambiguous the case for a single economic entity the less scope there is for rebutting the inference that a direct acquisition has led to a change of control.”²⁸⁸

The Tribunal then stated:

“The scope to accept argument about a single economic entity as a jurisdictional prerequisite must at this stage of the enquiry be limited to the clear cut cases suggested by section 4(5) with the added rider that section 4(5)(b) be strictly interpreted here.”²⁸⁹

And further:

“We must now consider on the facts of this matter:

1. whether the respondents have made out a case for being considered as a single economic entity as we have set out above for the purpose of section 12 adjudication; or
2. if we have too strictly construed the notion of single economic entity whether they have established that the respondents were the subject of some ultimate controller prior to the transaction who remains in control post transaction, or
3. if they have failed to meet either test proposed in the first two points the transaction meets the requirements for a merger in terms of section 12.”²⁹⁰

The Tribunal eventually, on the facts, held that the respondents were not part of a single economic unit. In principle, however, the Tribunal acknowledged that the concept of a single economic unit, where a group of companies is involved, would be recognised should it be proved that the companies within the group formed a single economic unit.

From the above case it is clear that the Competition Tribunal will not shy away from holding that a number of companies within a group may constitute a single economic unit. This “judgment” has set the tone for future judgments where it can be expected that the *Bulmer* judgment will be followed in the light also of the provisions of the Competition Act.

²⁸⁸ 463.

²⁸⁹ 465.

²⁹⁰ 465.

5.7.5 Contract law

In *Dithaba Platinum v Erconovaal Ltd*²⁹¹ the second respondent was an external company which wholly owned the first respondent. The second respondent granted a right of first refusal in respect of mineral rights to a company which in turn ceded these rights to the applicant. The second respondent then alienated the mineral rights to the first respondent as its wholly-owned local subsidiary. The applicant therefore sought an order compelling the respondents to cede the mineral rights to the applicant in terms of its right of first refusal. The applicant argued that the cession of the mineral rights from the second respondent to the first respondent triggered its right of first refusal. The respondents averred that the first respondent, as a wholly-owned subsidiary of the second respondent, was under the control of the second respondent and that the mineral rights were therefore still under the control of the second respondent and that therefore there was no disposal which would trigger the applicant's right of first refusal. The respondents in effect asked the court to ignore the separate legal personae of the first and second respondents which they themselves created.

The respondents in effect requested the court to pierce the veil of corporate personality and relied upon the remarks of Lord Denning MR in *Amalgamated Investments & Property Co Ltd (In liquidation) v Texas Commerce International Bank Ltd*²⁹² where the following was said:

“Apart from this, I think that this is one of those cases where a wholly-owned subsidiary is to be regarded as the alter ego of the parent company. We have often lifted the corporate veil so as to show forth the realities of company life. This wholly-owned subsidiary was the creature of the parent company. It did exactly what the parent company told it to do. It was nothing more nor less than a conduit pipe through which payments were made and received. It received no fees. It made no profits. It sustained no losses. Its transactions were all paper transactions, all book entries, recording the sums in and out. It was a puppet which danced to the bidding of the parent company just as Dr Wallersteiner's companies did (see *Wallersteiner v Moir* [1974] 3 All ER 217 at 238, [1974] 1 WLR 991 at 1013), and as the 'three in one' companies did in *DHN Food Distributors Ltd v London Borough of Tower Hamlets* [1976] 3 All ER 462, [1976] 1 WLR 852.”²⁹³

²⁹¹ *Dithaba Platinum v Erconovaal Ltd and Another* 1985 4 SA 615 (T).

²⁹² *Amalgamated Investments & Property Co Ltd (In liquidation) v Texas Commerce International Bank Ltd* [1981] 3 All ER 577 (CA).

²⁹³ 582E–G.

The South African court held that a court will not readily pierce the veil of corporate personality and referred to *Banco de Mocambique v Inter Science Research and Development Services (Pty) Ltd*²⁹⁴ (“Banco”) and agreed with the conclusions of the court in that case, which are that the corporate veil would only be pierced if the circumstances justify it, namely where the subsidiary was a sham or façade or on other recognised grounds.²⁹⁵

The court in *Dithaba* held, after looking at the *Banco* case, that it was not necessary for it to consider the very few South African cases where the courts have pierced the corporate veil. The court found that the cession agreement between the second respondent and the first respondent was a genuine contract, designed to vest the South African assets of an external company in its wholly-owned local subsidiary. They therefore could not be stigmatised as constituting a cloak, or a fiction or a sham. The framing of group accounts in the form chosen by the respondents did not, in the view of the court, advance their cause. According to the court they remained, as holding company and wholly-owned subsidiary respectively, separate personae with separate identities. As a result there had been a disposal by the first respondent which activated the applicant’s right of first refusal.²⁹⁶

In *Macadamia Finance BK v De Wet*²⁹⁷ the second appellant²⁹⁸ was the wholly-owned subsidiary of the first appellant. The first appellant and second appellant had mutual directors. The first appellant was placed in liquidation and the respondents were the liquidators. The second appellant was the registered owner of a farm. The assets on the farm were destroyed by fire and flooding. The first appellant claimed damages from the respondents and based their claim on the averment that the respondents, in their

²⁹⁴ *Banco de Mocambique v Inter Science Research and Development Services (Pty) Ltd* 1982 3 SA 330 (T).

²⁹⁵ 624F-625F.

²⁹⁶ 625G-H. Although this case was decided some 10 years before the *Cape Pacific* case (see para 2.7.2 above) it is submitted that the result would have been the same.

²⁹⁷ *Macadamia Finance BK en ‘n Ander v De Wet en Andere NNO* 1993 2 SA 743 (A).

²⁹⁸ According to the facts set out in the judgment of the court *a quo*, *Macademia Finance Ltd v De Wet en Andere NNO* 1991 4 SA 273 (T) 274I-J, the first appellant, Macademia Finance BK, was initially a public company that was subsequently converted into a close corporation.

capacities as liquidators of the first appellant, had a legal duty to the second appellant (which was not then in liquidation) to insure the assets of the second appellant. The first appellant mistakenly did not claim damages from the respondents based on the insurable interest that the first appellant had in the second appellant, i.e. the second appellant was an asset of the first appellant and as such the respondents may have had a duty of care to take proper care of the assets of the first appellant. Instead the claim of the first appellant was based on the assumption that the respondents had a legal duty to protect the assets of the second appellant.

One of the arguments that the appellants raised to support their claim was that the first appellant and its wholly owned subsidiaries (of which the second appellant was one) constituted a single economic unit. The appellants referred to a number of English cases where the concept of a single economic unit was raised and applied. The Appellate Division (as it then was), however, rejected the argument of the appellants based on the circumstances of the case and also referred to the fact²⁹⁹ that the cases that the appellants relied on had been subjected to a restrictive analysis and discussion in the decision of the English Court of Appeal in *Adams v Cape Industries plc.*³⁰⁰ Botha JA then held as follows with reference to the single economic unit argument that the appellants raised:

“Ek stem saam met die bevinding van De Villiers R (op 280H en 281E-F) dat die appellante se saak nie bevorder word deur die beskouing van die twee appellante as deel van 'n ekonomiese eenheid nie. Hoe heg die eenheid ook al mag gewees het, en wat ook al die gevolge daarvan in ander omstandighede mag gewees het, kon dit nie die likwidasië van die eerste appellant oorleef het op 'n wyse wat dit moontlik maak om die voortbestaan van die tweede appellant en sy eie direksie te negeer nie. Dit kan ook nie die gedagte onderskraag dat die respondent die beheer en bestuur van die tweede appellant oorgeneem het nie; die onhoudbaarheid van daardie gedagte bly steeds, om die redes reeds genoem, 'n onoorkomelike struikelblok in die weg van die appellante.”³⁰¹

²⁹⁹ 748D.

³⁰⁰ [1990] Ch 433 CA, [1991] 1 All ER 929 (Ch and CA). See also para 6.1 below.

³⁰¹ 748D-F. “I agree with the finding of De Villiers J that the case of the appellants is not advanced by the view that the two appellants are part of a single economic unit. No matter how close the unit may have been, [...], it could not survive the liquidation of the first appellant.

Both the *Dithaba* and the *Macadamia* cases follow the traditional approach of recognising the separate identity of the individual companies within the group. The decision in the *Dithaba* case is also understandable in the light of the fact that the companies chose to operate as separate entities and effectively asked the court to ignore the walls between the entities which they themselves created. It is also noteworthy that the court in *Dithaba* was strongly influenced by the *Adams v Cape plc* case.

5.7.6 The law of delict

In *Wambach v Maizecor Industries (Edms) Bpk*³⁰² the court had to decide on the question of ownership of a vehicle within a group of companies. A mechanical horse and trailer were damaged in an accident and the respondent sought damages from the appellant. The appellant denied that the respondent was the owner of the mechanical horse and trailer. From the facts it appeared that a wholly-owned subsidiary of the respondent was the registered owner of the mechanical horse and trailer and that for income-tax purposes the horse and trailer were accounted for as an asset of another wholly-owned subsidiary of the respondent. It also appeared to the court that the board of directors of the respondent acted as the *de facto* board of directors of all the subsidiaries, including the registered owner of the horse and trailer.

The respondent argued that ownership vested in the respondent since the board of directors controlled the alienation thereof by means of its control over the subsidiary. The court had the following to say about this argument:

“Die feit dat die direksie van 'n kontrolerende maatskappy effektiewelik oor die lotgevalle van 'n bate van 'n filiaal besluite kan neem, bring egter nie mee dat dit daarom 'n bate van die kontrolerende maatskappy is nie. Spesifiek wat vervreemding betref, bly die betrokke saak 'n bate van die filiaal totdat gevolg gegee word aan 'n vervreemdingsbesluit. Op sy beste vir die respondent was die posisie van sy direksie analoog tot dié van 'n agent wat deur sy prinsipaal gemagtig is om laasgenoemde se bate te vervreem. Totdat vervreemding geskied, bly die saak die eiendom van die prinsipaal.”³⁰³

³⁰² *Wambach v Maizecor Industries (Edms) Bpk* 1993 2 SA 669 (A).

³⁰³ 674H-675B. “The mere fact that the board of the controlling company effectively can decide what the fate of an asset of the subsidiary will be, does not imply that it therefore becomes an asset of the controlling company. Specifically in respect of the alienation of the asset, the asset remains an asset of the subsidiary until effect is given to the decision to alienate. At best for the respondent the position of the board is akin to that of an agent who has

The respondent also tried to rely on English cases where the commercial reality of a group was recognised. The court responded as follows:

“Die respondent se advokaat het tereg aanvaar dat die respondent en Bemerkings afsonderlike entiteite is, elk met sy eie regte en verpligtinge. Hy het hom egter beroep op 'n aantal - meestal Engelse - gewysdes waarin, so is aangevoer, daar 'n ontsluiting van korporatiewe identiteite plaasgevind het ten einde gevolg te gee aan kommersiële realiteite. Nie een van dié gewysdes is in die onderhawige geval van nut nie. Enige poging tot ontsluiting lei tot totale duisternis.”³⁰⁴

The court further held that *Adams v Cape Industries plc*³⁰⁵ rejected these earlier decisions that the respondent referred to. The facts in *Wambach* were in a way the converse of the *DHN*³⁰⁶ decision in the light of the fact that the plaintiff wanted to use the economic entity argument against the group.

The *Wambach* case is illustrative of the problem before the courts but also faced by persons who were harmed by the actions of a member of a company group. This problem will be investigated in depth in chapter 6 below.

5.7.7 Intellectual property law

In *Adcock-Ingram Laboratories Ltd v SA Druggists Ltd; Adcock-Ingram Laboratories Ltd v Lennon Ltd*³⁰⁷ the issue to be decided was whether use of a trade mark by a wholly-owned subsidiary of the registered owner of the trade mark constituted use by the registered owner for the purposes of the Trade Marks Act.³⁰⁸ The court held that such use did not constitute use by the registered owner in terms of the Act.

been authorised by his principal to alienate an asset of the latter. Until alienation occurs the asset remains the property of the principal.”

³⁰⁴ 675C. “None of the [English decisions] is of any use in this instance. Any attempt to lift the veil leads to total darkness.”

³⁰⁵ [1990] 1 Ch 433; [1991] 1 All ER 929 (Ch and CA). See para 6.1 below for a detailed discussion of the *Adams* case.

³⁰⁶ See para 3.10 above.

³⁰⁷ *Adcock-Ingram Laboratories Ltd v SA Druggists Ltd and Another; Adcock-Ingram Laboratories Ltd v Lennon Ltd* 1983 2 SA 350 (T).

³⁰⁸ S 48(1) and (2) read with s 36(1)(b) of Act 62 of 1963.

In *Ritz Hotel Ltd v Charles of the Ritz Ltd*³⁰⁹ a similar situation arose as in the *Adcock-Ingram* case. The court had to decide whether there was use by the registered owner of a trade mark. The respondent was the wholly-owned subsidiary of the United States company. The United States company provided technical support to the respondent. There was no relationship between the United States company and the registered user of the trade mark in issue, African Sales Co (Pty) Ltd. The respondent, however, could compel the registered user to comply with any conditions and restrictions which were imposed by the registration of the relevant trade mark. According to the Appellate Division “[a]ny services provided by the US company to African Sales, and any control exercised, could only be as a result of a request, either express or tacit, by the respondent to the US company.”³¹⁰ It follows that the services and control must have been performed by the technical services division at the behest of the respondent and on its behalf. On the facts the court ultimately held that the holding company exercised control over the subsidiary in respect of the use of the trade mark and therefore the mark was used by the registered owner.

The court furthermore looked at the relationship between a holding company and its subsidiary but stated that:

“It is clear that the acts of a holding company are not per se the acts of its wholly-owned subsidiary, or vice versa, since the holding company is a separate legal entity from its subsidiary; but in recent years, there has become evident in the English cases a more relaxed approach to the application of this basic principle.”³¹¹

The court referred to Gower³¹² who acknowledged that in certain cases the realities of a group as an entity should be recognised. The court also referred to *DHN Food Distributors Ltd v Tower Hamlets London Borough Council*³¹³ where the court recognised the principle of a group of companies as constituting an economic entity. The court then stated the following:

³⁰⁹ *Ritz Hotel Ltd v Charles of the Ritz Ltd and Another* 1988 3 SA 290 (AD).

³¹⁰ 317C-D.

³¹¹ 314H-I.

³¹² Gower *Principles of Modern Company Law* 4ed (1979) 128-9.

³¹³ [1976] 1 WLR 852 (CA) at 860B; [1976] 3 All ER 462 at 467 b-c. See para 3.10 above.

“It may become necessary to reconsider *Adcock-Ingram Laboratories Ltd v SA Druggists Ltd and Another; Adcock-Ingram Laboratories Ltd v Lennon Ltd* 1983 (2) SA 350 (T) where I held that use of a trade mark by a wholly-owned subsidiary of the registered proprietor was not used by the proprietor.”³¹⁴

Subsequently, however, in *AM Moolla Group Ltd and Others v The Gap Inc and Others*³¹⁵ the Supreme Court of Appeal recently held that use within a group of companies did not constitute use by the registered proprietor or use by a third party under license of the proprietor. This was, however, decided purely on the facts of the case. Interestingly enough there is no reference to the *Ritz Hotel* and the *Adcock-Ingram* cases.

5.8 Evaluation of the law pertaining to company groups in South Africa

The purpose of this section firstly will be to summarise the law of company groups in South Africa as reflected by legislation and the judiciary as has been set out above. The further purpose is to determine whether that law is adequate in the light of the fact, as has been shown above,³¹⁶ that the principle of limited liability is suspect historically as well as economically in a number of situations. In this respect the purpose of company law regarding the question as to whose interests a company should be serving will be investigated. This is important for the purposes of this dissertation since it starts from the premise that third parties who deal with the company, either voluntarily or involuntarily, are not adequately protected by the law regarding company groups at present.

The *Dithaba*³¹⁷ case was decided when the doctrine of piercing of the corporate veil was still in its infancy and therefore very well reasoned in light of the *DHN*³¹⁸ case which easily could have resulted in a different conclusion. The *Wambach*³¹⁹ and *Macadamia*

³¹⁴ 316A-B.

³¹⁵ *AM Moolla Group Ltd and Others v The Gap Inc and Others* 2005 6 SA 568 (SCA).

³¹⁶ See chapters 2 and 3 above.

³¹⁷ *Dithaba Platinum v Erconovaal Ltd and Another* 1985 4 SA 615 (TPD).

³¹⁸ *D.H.N. Food Distributors Ltd v Tower Hamlets London Borough Council, Bronze Investments Ltd v Tower Hamlets London Borough Council and D.H.N. Food Transport Ltd v Tower Hamlets London Borough Council* [1976] 1 W.L.R. 852.

³¹⁹ *Wambach v Maizecor Industries (Edms) Bpk* 1993 2 SA 669 (A).

*Finance*³²⁰ cases were both decided after the English decision in *Adams v Cape plc*³²¹ where the *DHN* decision was rejected.

The *Adcock-Ingram* and *Ritz Hotel* cases were both after the *DHN* case but prior to the *Adams v Cape plc* case and the influence of the *DHN* case can be seen in especially the *Ritz Hotel* case. Strangely enough the Appellate Division in the *Ritz Hotel* decision failed to refer to the *Dithaba* judgment.

The labour-law cases are anomalous since the courts in earlier decisions recognised that a group of companies could be treated as a single entity as seen in the *Contract Installations*³²² and *Kaycraft*³²³ cases, which again precede the *Adams v Cape plc* case. The other labour-law cases neatly sidestepped dealing with groups as a concept by holding that the employees in those specific cases had multiple employers.³²⁴

The one case in competition law, where the current legislation in South Africa is still comparatively new, recognised the concept of a single economic unit in respect of a group of companies.³²⁵ Given that the legislation in this area is so new, it could be viewed as a radical step. On the other hand, the Tribunal could not close its eyes to the provisions of the Competition Act as well as to foreign jurisprudence on comparable situations. One can therefore expect a progressive acceptance of this doctrine in future cases before the Tribunal where the facts support the concept of a single economic entity. What can be gathered from the above is that the *DHN* case had a strong influence on a few South African cases prior to the *Adams v Cape plc*³²⁶ decision.

It does seem that South African company law has adopted a more rigid approach to limited liability and that exceptions will be few and far between. The new Companies Act

³²⁰ *Macadamia Finance BK en 'n Ander v De Wet en Andere NNO* 1993 2 SA 743 (A).

³²¹ [1990] Ch 433 CA, [1991] 1 All ER 929 (Ch and CA). .

³²² *SA Allied Workers Union & Others v Contract Installations (Pty) Ltd & Another* 1988 9 ILJ 112 (IC).

³²³ *Paper, Printing, Wood and Allied Workers Union & Others v Kaycraft (Pty) Ltd & Another* 1989 10 ILJ 272 (IC).

³²⁴ See para 5.7.3 above.

³²⁵ *Bulmer SA (Pty) Ltd v Distillers Corporation (SA) Ltd* (1) [2001-2002] CPLR 448 (CT), para 5.7.4 above.

³²⁶ See chapter 6.

has not changed this approach and there are hardly any provisions which cut through the separate juristic personality, except the consolidated financial statements which are (probably) required in respect of groups and in the case of the personal liability company where the directors are liable for the contractual debts of the company.³²⁷

It has been shown that the veil of limited liability will be pierced by the courts in certain cases. The tests as set out by the courts are however strict, especially after the *Adams v Cape Industries plc*³²⁸ decision. The *Adams* decision is also still good law in England, twenty years after being decided.³²⁹ The *Adams* decision has therefore brought much certainty in the English law regarding the piercing of the corporate veil. With certainty, predictability follows which makes the provision of legal advice a much simpler task. It is arguable from the case law that the courts in the United States of America follow a more flexible approach.³³⁰ The South African courts have followed the direction of the English judiciary in choosing the path of certainty and predictability instead of the path of flexibility regarding the piercing of the corporate veil. The question is whether this path is the correct one, not only for the judiciary but also for the legislature in the context of company groups. Is limited liability with the piercing of the corporate veil as the only exception still the path that should be followed?

In general terms it is certainly not the aim of this dissertation to provide any legal philosophical answer to what the law on piercing of the corporate veil in the context of company groups should be. As mentioned above two trains of thought seemingly exist in respect of the piercing of the corporate veil. There is the strict English/South African approach compared to the position in the United States, which tends to favour flexibility above certainty, as will be shown in chapter 6. The approach in South Africa therefore appears to be a more legal positivistic approach viewing the law as it is instead of how it

³²⁷ S 53(b) of the 1973 Companies Act and section 19(3) of the new Companies Act. See also s 163(4), para 5.3.9 above.

³²⁸ Above and see para 6.1 for further detail.

³²⁹ *Brookes v Borough Care Services* [1998] I.C.R 1198; I.R.L.R. 636 (EAT), *Trustor AB v Smallbone* (no4) [2001] All E.R. 987, *Harrods Ltd v Dow Jones & Co Inc* [2003] EWHC 1162 (QBD), *Lucasfilm Ltd v Ainsworth* [2009] F.S.R. 2, *OJSC Oil Company Yugraneft (in liquidation) v Roman Arkadievich Abramovich, Millhouse Capital UK Limited, Boris Berezovsky* 2008 WL 4698908 [2008] EWHC 2613 (Comm) QBD (Comm).

³³⁰ See chapter 6 below.

ought to be. The aim of this approach, as it has evolved,³³¹ is to have order and therefore certainty.³³² There are however conflicting values which have to be borne in mind. Van Niekerk³³³ refers to conflicting maxims *salus populi suprema lex esto*,³³⁴ *iustitia fundamentum regnorum*,³³⁵ *fiat iustitia, pereat mundus*³³⁶ and *summum ius, summa iniuria*.³³⁷ The legal environment in the United States has long been viewed, especially in the early and mid twentieth century, as being based on realism.³³⁸ The most radical of the realists was Frank for whom the law was and should be inherently uncertain. Frank was of the view that legal rules were not the foundation of a decision but that law making is influenced by “emotions, intuitive hunches, prejudices and other irrational factors”.³³⁹ The uncertainty which followed was for Frank socially valuable.³⁴⁰ The *prima facie* view of the law on the piercing of the corporate veil in the United States is one of realism and not one of positivism, as explained in the next chapter.

Over and above the value or reason for law and legal rules the next more concrete question concerns that of whom the company serves. Does it only have the interests of its shareholders at heart or does the company serve a wider range of interested parties? The answer to this is important. The broader view of the two possible interests is conducive to the imposition of more extensive liability on the management of the company and by extension possibly on its holding company as well. Davis *et al* state that the new

³³¹ See, for example Gower *Principles of Modern Company Law* 4ed (1979) 128-9 as quoted in the *Ritz Hotel* case above. Gower stated in the context of company groups that “The trouble is that the attitude of the Courts is unpredictable. Each case where they have regarded the subsidiary as agent of the parent can be matched with another in which they have refused to do so. Indeed, in one case it was said in the Court of Appeal that:

‘Under the ordinary rules of law, a parent company and a subsidiary company, even a 100 percent subsidiary company, are distinct legal entities, and in the absence of an agency contract between the two companies one cannot be said to be the agent of the other.’” It would appear that this uncertainty has been replaced by certainty following the *Adams v Cape plc* decision.

³³² See in general Radbruch “Legal Philosophy” in *20th Century Legal Philosophy Series*, translated by Kurt Wilk, Harvard University Press 1950 43, Van Niekerk “The Warning Voice from Heidelberg-The Life and thought of Gustav Radbruch” 1973 *SALJ* 90 234; Kroeze *Legal Positivism* in Roederer & Moellendorf *Jurisprudence* (2004) 62-83.

³³³ Van Niekerk “The Warning Voice from Heidelberg-The Life and thought of Gustav Radbruch” 1973 *SALJ* 90 252 refers to Radbruch *Vorschule der Rechtsphilosophie* 3ed (1965) 32-33.

³³⁴ Utility is the sole criterion for the law.

³³⁵ Justice is the foundation of all law.

³³⁶ The positive law is to prevail over all other legal values.

³³⁷ The positive law in its absolute form becomes injustice.

³³⁸ See in general Hoctor *Legal Realism* in Roederer & Moellendorf *Jurisprudence* 158.

³³⁹ Hoctor *Legal Realism* 168.

³⁴⁰ Hoctor *Legal Realism* 168.

Companies Act moves away from the traditional shareholder-orientated model to the enlightened shareholder value approach,³⁴¹ with more regard for other stakeholders.³⁴² It has been pointed out above that the new Companies Act provides that the directors of a company should not knowingly cause harm to the company or its subsidiary.³⁴³ What is meant by the subsidiary company in this context? Is it its shareholders or is its ambit supposed to stretch wider? What if the subsidiary is a wholly-owned subsidiary? What if a certain action is to the benefit of the holding company but to the disadvantage of the subsidiary company?

The point of departure is that a director only has a fiduciary duty to the company of which he is a director.³⁴⁴ Within the context of a group of companies, therefore, the point of departure is still that the directors of the holding company do not owe a duty to the subsidiary company. In *Scottish Co-operative Wholesale Society Ltd v Meyer*,³⁴⁵ however, the court held that in the case where the holding company placed its nominee directors on the board of the subsidiary company:

“nominees of a parent company upon the board of a subsidiary company may be placed in a difficult and delicate position. It is, then, the more incumbent on the parent company to behave with scrupulous fairness to the minority shareholders and to avoid imposing upon their nominees the alternative of disregarding their instructions or betraying the interests of the minority. In the present case the society pursued a different course. It was ruthless and unscrupulous in design and it was effective in operation, and, as I have said, it was promoted by the action or inaction of the nominee directors.”³⁴⁶

The court therefore held, in the situation where the holding company in effect usurps the functioning of the subsidiary, that there is a duty on the holding company not to act to the detriment of the subsidiary company. In *Kuwait Asia Bank v National Mutual Life Nominees Ltd*³⁴⁷ the Privy Council stated that:

³⁴¹ See below.

³⁴² Davis, Cassim & Geach (eds) *Companies and other Business Structures in South Africa* (2006) 10-11.

³⁴³ S 76(2)(a)(ii).

³⁴⁴ *Percival v Wright* [1902] 2 Ch 421 and see Blackman et al *Commentary Revision Service* 3 2006 8-51.

³⁴⁵ [1959] AC 324; [1958] 3 All ER 66 (HL).

³⁴⁶ 341.

³⁴⁷ [1990] 3 All ER 404 (PC); [1991] 1 AC 187.

“An employer who is also a shareholder who nominates a director owes no duty to the company unless the employer interferes with the affairs of the company. A duty does not arise because the employee may be dismissed from his employment by the employer or from his directorship by the shareholder or because the employer does not provide sufficient time or facilities to enable the director to carry out his duties. It will be in the interests of the employer to see that the director discharges his duty to the company but this again stems from self-interest and not from duty on the part of the employer.”³⁴⁸

If the holding company exploits its position, therefore, it could become liable for the acts of the subsidiary company. The position could therefore be that the holding company could have a duty to the subsidiary company in certain circumstances as pointed out by the *Scottish Co-operative* and *Kuwait Asia Bank* cases. Blackman argues that this is not a fiduciary duty which the holding company or nominee directors have but that they do owe the subsidiary a duty of not interfering with its independence and not to undermine the independence of the subsidiary.³⁴⁹ In *Robinson v Randfontein Estates Gold Mining Co Ltd*³⁵⁰ the court stated that:

“A man, who procures the election of a board of directors under circumstances which make it impossible for them to exercise an independent judgment, must, in my opinion, observe the utmost good faith in his dealings with the company, which he has, of set purpose, deprived of independent advice. The duty to do so arises from the circumstances which he has chosen to bring about and it is wholly inconsistent with the obligations of good faith that the defendant should have made for himself these profits by the method which the evidence discloses.”³⁵¹

In *Nicholas v Soundcraft Electronics Ltd*³⁵² the court with reference to the *Scottish Co-operative* case stated that

“The truth is that, whenever a subsidiary is formed as in this case with an independent minority of shareholders, the parent company must, if it is engaged in the same class of business, accept as a result of having formed such a subsidiary an obligation so to conduct what are in a sense its own affairs as to deal fairly with its subsidiary. That language was wholly apposite in the *Scottish Co-operative* case where the two companies were engaged in the same business and the parent was appropriating to itself the business, or part of the business, of the subsidiary. *But I do not read the*

³⁴⁸ 424.

³⁴⁹ Blackman et al *Commentary* Revision Service 5 8-56.

³⁵⁰ *Robinson v Randfontein Estates Gold Mining Co Ltd* 1921 AD 168, 182 above.

³⁵¹ 196.

³⁵² *Nicholas v Soundcraft Electronics Ltd* [1993] BCLC 360 (CA).

*Lord President's words as in any way limiting the obligation of the parent if it is actually conducting the affairs of the subsidiary, and whether the two companies are engaged in the same class of business or not, from acting fairly towards the subsidiary.*³⁵³

The independence of the subsidiary is therefore important. If the holding company conducts the business of the subsidiary or the board of the subsidiary is not independent, in that it is submissive to the holding company's board, there could be a duty on the holding company to take the interests of the subsidiary company into consideration. The question, however, remains as to whom the duty is owed. Is it to the shareholders or to a wider group of interested parties?

Hadden³⁵⁴ lists a number of interested parties in a group which may be classified as internal and external interested parties. These interested parties are management and investors (the internal interested parties), and employees, creditors, government and the public at large (the external interested parties).³⁵⁵ Havenga argues for the retention of the fiduciary duty to the company but that the interests of other stakeholders should also be considered.³⁵⁶ She highlights the conflicts which could arise between the interests of the various stakeholders and how difficult it would be to reconcile these conflicting interests. This could lead to decisions not being taken because of the conflicting interests of shareholders and employees and other interested groups. The shareholders would necessarily want profits to be declared as dividends. Employees would want to have increases in their salaries. The community within which the company operates would like to see social upliftment taking place, the environment surrounding the company's operations to be maintained and its creditors would like to be paid as soon as possible. Being a director under such a regime may become an exercise in impossibility if the director has to balance the interests of all of these stakeholders.

³⁵³ 364-365, my italics.

³⁵⁴ Hadden *The Control of Corporate Groups* (1983).

³⁵⁵ Hadden *Control* 20 – 24.

³⁵⁶ Havenga "Directors' Fiduciary Duties Under Our Future Company-law Regime" (1997) 9 *SA Merc LJ* 310 317.

The expansion of the duty of directors to other stakeholders has been considered by a number of writers.³⁵⁷ Also the various King Codes on corporate governance have to varying degrees addressed the role of directors towards the various stakeholders of the company including creditors. The first King Code on corporate governance was released in 1994. The aim of the first code was, amongst others, to set out proper guidelines for the management of companies. The second King Code was released in March 2002 and was applicable until 28 February 2010 when it was replaced by the King III Report and Code on Corporate Governance.

The second King Code was only applicable to companies which were listed on the JSE. Other companies were free to adopt the code. The second King Code acknowledged that there was a movement away from the single bottom line to a triple bottom line in respect of the activities of companies. This means that companies were to take the environmental, social and economic aspects into consideration when deciding on their activities. Social aspects included the “reciprocal relationships” with other interested parties and not only the shareholders.³⁵⁸ The code proceeded by mentioning that the triple bottom line requirement demanded that ownership assumes responsibility.³⁵⁹ In the light of the fact that King III replaced King II in March 2010 no further discussion of King II will be undertaken. It suffices to say that King II realised that a (board of a) company does not only have responsibilities to the shareholders of the company but that other interested parties also have an interest in the manner in which a company is operated.

The King Report on Governance for South Africa and the King Code of Governance Principles³⁶⁰ were published in 2009 and came into effect on 1 March 2010.³⁶¹ King III became necessary in the light of the introduction of the new Companies Act. The authors of King III envisage that King III will apply to all entities although the basis of application is not clear. The King Code is not legislation and the only way it can apply to all entities is either by voluntary adoption or through the imposition of King III by bodies

³⁵⁷ See, for example Davis et al *Companies and other Business Structures* 10-11.

³⁵⁸ 17.1 of King II.

³⁵⁹ 17.3 of King III.

³⁶⁰ King III.

³⁶¹ King III Report 14.

like the JSE. King III adopts the “apply or explain” approach like the Netherlands Code to leave scope for individual companies to adapt the Code for their needs and leaves it to them as to how to apply the principles of King III.

King III mentions that one of the philosophies of the code is corporate citizenship.³⁶² King III continues to adopt the triple bottom line approach in terms of which the company does not only take into account the interests of the shareholders, but that it should also be a responsible citizen. King III affirms the policy in King I and King II in respect of the responsibility of the board of the company, namely that the board should consider the interests of all interested parties and not only the shareholders of the company. The interested parties include external stakeholders who are necessary for the viability of the company, which would include voluntary creditors.³⁶³ King III is of the opinion that an inclusive stakeholder approach can influence the long-term growth of the company. Over and above creditors, consumers are also seen as stakeholders by King III,³⁶⁴ a perspective which comes from the Consumer Protection Act.³⁶⁵ King III recognises the difficulty in balancing the often conflicting interests of the various stakeholders in a company and therefore sets out as a principle that the board should strive to balance these conflicting interests in the best interests of the company.³⁶⁶ The position of creditors is also of much more prominence now in the light of the fact that the new Companies Act provides for extensive business rescue measures.³⁶⁷ King III also provides that the board should consider these proceedings or other measures to turn the company around when it is in financial difficulty.³⁶⁸

Esser argues that King III is a significant improvement on King II and that the relevant principles highlighted above are an acknowledgement that the board of a company has to

³⁶² King III Report 8.

³⁶³ King III Report chapter 1 11.

³⁶⁴ Chapter 8, principle 8.1.

³⁶⁵ Para 5.6 above.

³⁶⁶ Principle 8.3. See also generally principles 8.1 and 8.2.

³⁶⁷ Ss 128 – 154 and also s 155.

³⁶⁸ Principle 2.15 and see chapter 6 below.

consider the interests of the various stakeholders, who have an interest in the company.³⁶⁹ The new Companies Act, however, does not apparently confirm this approach. The new Companies Act merely states that directors must, among other considerations, act in the best interests of the company.³⁷⁰ When one considers the purposes of the new Companies Act, there appears to be an acknowledgement of the wider interests which are to be served by a company.³⁷¹ In the light of the principle in the interpretation of statutes that the legislature is not deemed to have amended the common law unless specifically stated, it is to be assumed that the new Companies Act confirms the common-law principle that the duty of the board is towards the shareholders and not to other stakeholders as well unless specifically stated. It is submitted that the fact that the legislature also specifically mentions the duty of directors to subsidiary companies³⁷² (contrary to the common law) confirms the restrictive view that the directors have a duty to the company in the narrow sense. The fact that the legislature thought of the position of a subsidiary implies that it considered the position of other stakeholders in the company since the subsidiary is also a stakeholder in the operations of the holding company. It therefore did not deem it necessary to extend the duty of directors to other stakeholders.³⁷³

King III also addresses groups of companies.³⁷⁴ It addresses the need for holding companies to respect the fact that the directors of the subsidiary company have fiduciary duties to the subsidiary company³⁷⁵ and importantly that the adoption and implementation of the policies and procedures of the holding company should be in the discretion of the board of the subsidiary company, and if the board of the subsidiary considers it to be appropriate.³⁷⁶

³⁶⁹ Esser “The Protection of Stakeholder Interests in terms of the South African King III Report on Corporate Governance” (2009) 21 *SA Merc LJ* 188 – 201.

³⁷⁰ S 76(3)(b). Section 76(3) applies to the “directors” rather than the “board” as such.

³⁷¹ S 7(b)(iii), (d), (e), (k) but compare s 7(i) which only refers to directors and shareholders.

³⁷² S 76 (2)(a)(ii).

³⁷³ See, however, s 7 referred to above which does acknowledge wider interests which are to be considered in certain circumstances. S 128(1)(b) “business rescue” (iii) refers to the interests of the creditors which will hopefully be promoted by the business rescue provisions. S 128(1)(a) “affected person” (i) includes a creditor of a company in the context of business rescue proceedings.

³⁷⁴ Principle 2.24.

³⁷⁵ Principle 2.24, 142.

³⁷⁶ Principle 2.24, 145.

The English Companies Act³⁷⁷ specifically provides for directors to take the interests of all stakeholders into consideration. The English Companies Act provides as follows

“A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to-

- (a) the likely consequences of any decision in the long term,
 - (b) the interests of the company's employees,
 - (c) the need to foster the company's business relationships with suppliers, customers and others,
 - (d) the impact of the company's operations on the community and the environment,
 - (e) the desirability of the company maintaining a reputation for high standards of business conduct, and
 - (f) the need to act fairly as between members of the company.
- (2) Where or to the extent that the purposes of the company consist of or include purposes other than the benefit of its members, subsection (1) has effect as if the reference to promoting the success of the company for the benefit of its members were to achieving those purposes.
- (3) The duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company.”³⁷⁸

The point of departure is still the interests of the shareholders of the company. Keay refers to the approach in the English Companies Act of 2006 as the “shareholders first” approach.³⁷⁹ He argues that the interests of the shareholders are the most important and that the directors of the company only have to take the interests of the other stakeholders into consideration if this serves the interests of the shareholders.³⁸⁰

The question therefore is whether the South African legislature was correct to circumscribe the duties of directors restrictively, namely that the directors in general only

³⁷⁷ Companies Act 2006, which came into effect on 1 October 2007 and also applies to Wales, Scotland and Northern Ireland.

³⁷⁸ S 172.

³⁷⁹ Keay “Tackling the Issue of the Corporate Objective: An Analysis of the United Kingdom’s Enlightened Shareholder Value Approach” 29 *Sydney Law Review* 577 592.

³⁸⁰ Keay *Enlightened Shareholder Value Approach* 592.

owe a duty to the shareholders of the company.³⁸¹ By extension it could be asked in the light of the *Scottish Co-operative*³⁸² and the *Kuwait Asia Bank*³⁸³ cases whether the holding company could have duties to other stakeholders of the subsidiary company in certain circumstances. Firstly, however, it should be asked why must the directors take the interests of other interested parties into consideration?

Jensen³⁸⁴ argues that to extend the duty of directors to other stakeholders would often make it difficult for them to take effective decisions having regard to the various stakeholders which they have to satisfy.³⁸⁵ However he recognises that the stakeholder theory does have some corporate use. He looks, as his point of departure, at what would provide maximum value to an entity. Value for Jensen here means long-term value and such value cannot be created without having good relations with creditors, employees and communities, customers or government.³⁸⁶ This approach Jensen calls the Enlightened Value Maximization Approach. He also looks at an Enlightened Stakeholder Approach. Jensen views this approach as one which aims to maximise long-term market value of the firm.³⁸⁷ The long-term value will enhance the position of shareholders but it also allows management to assess the trade-offs which need to be made among competing stakeholders.³⁸⁸ In short, a company which is successful in the long term ensures the long-term success of the stakeholders of the company.

Keye summarises the criticisms of various authors of the shareholder primacy model. The first point of criticism is that it fails to maximise social wealth and that the focus on short-term wealth prejudices some stakeholders like employees and consumers.³⁸⁹ There is also an argument that the risk which shareholders bear should not be overestimated

³⁸¹ See s 7 above, s 128(1)(b) above and s 5(1) and (2) which provide that the new Companies Act has to be interpreted in a manner that gives effect to the purposes in s 7 and furthermore that foreign law may be considered by a court when it interprets or applies the new Companies Act.

³⁸² Above.

³⁸³ Above.

³⁸⁴ Jensen "Value Maximization, Stakeholder Theory, and the Corporate Objective Function" *Journal of Applied Corporate Finance* Volume 14.3 (2001) 8.

³⁸⁵ 9.

³⁸⁶ 16.

³⁸⁷ 17.

³⁸⁸ 17.

³⁸⁹ Keye *Enlightened Shareholder Value Approach* 585.

since other stakeholders also bear risk. Employees for example could receive such specialised training within a company that it reduces their employment mobility. The employees concerned therefore become prisoners of that enterprise.³⁹⁰

Keay also points out the normative arguments which some authors have raised against shareholder value. Authors who hold a communitarian view of company law argue that a company should be managed for the benefit of all the stakeholders of the company like creditors, consumers and the community within which the company operates. For these authors, companies should have a broad social purpose instead of being solely focused on profit for the benefit of their shareholders. Furthermore, company law should become less de-personalised and those managing the company should realise that the majority of corporate acts actually affect human beings.³⁹¹ The communitarians depart from the point of view that people are:

“part of a shared community who inherit the benefits, values and goals of the community, thus the cultural milieu in which people find themselves cannot be ignored, and the company is regarded as ‘a community of interdependence, mutual trust and reciprocal benefit.’ The interests of shareholders are [therefore] not the only interests to be considered by directors when carrying out their functions, for there are other important constituencies that warrant the consideration of directors.”³⁹²

This view of the communitarians is based on the ideology that the state grants the company its status but also that by granting this status to the company, the company becomes an instrument for the state to use. The commercial goal of a company becomes irrelevant and it merely becomes a tool for the state to further its political goals which are of a social nature.³⁹³

Keay also refers to other authors who do not focus on moral arguments but instead focus on a combination of economics and ethics. The result of this is the stakeholder theory which in essence implies that a company should take a long term view of its operations

³⁹⁰ Keay *Enlightened Shareholder Value Approach* 586.

³⁹¹ Keay *Enlightened Shareholder Value Approach* 586.

³⁹² Keay *Enlightened Shareholder Value Approach* 586.

³⁹³ Dine *The Governance of Corporate Groups* (2000) 17.

which will ultimately lead to a win-win situation if all the role players pull in the same direction.³⁹⁴

5.9 Summary

It would appear from the evaluation above that the following position has emerged in South Africa as regards company groups. The new Companies Act has restricted the potential for abuse within groups by introducing the solvency and liquidity requirement for a number of intra-group transactions, including the provision of financial assistance for the acquisition of securities of a related or inter-related company. Provision is also made for business rescue measures, which could be important when read with King III and the *Scottish Co-operative* and *Kuwait Asia Bank* cases. Furthermore, the new Companies Act does recognise that there are interested parties other than shareholders in a company. Although it is not expressly stated that the directors of a company have fiduciary duties to other interested parties, it has been shown that some provisions in the new Companies Act require that the interests of creditors of the company should be recognised in some circumstances. Another interesting provision is the partial extension of the fiduciary duties of directors of the holding company to the subsidiary company. It is, however, not clear how the directors will have to balance the conflicting interests if the interests of the holding company differ from those of the subsidiary.

It has also been shown that new legislation like the Competition Act in appropriate circumstances recognises some company groups as a single economic unit. The Consumer Protection Act, which provides for strict liability for any entity within the production and retail chain, and which allows the consumer to claim from any company within the chain, will potentially also impact on group activities.

From a legislative perspective, therefore, it has been shown that the new Companies Act does not fundamentally depart from the traditional approach of limited liability regarding company groups. There have been improvements to protect creditors and minority shareholders by means of the solvency and liquidity requirement but creditors, especially

³⁹⁴ Keay *Enlightened Shareholder Value Approach* 588 and see also Jensen above.

involuntary creditors of the subsidiary, are still inadequately protected. More recent legislation like the Consumer Protection Act and the Competition Act, however, does recognise that a group of companies can be a single economic unit.

The judiciary on the other hand has not moved much, if at all, from the traditional approach of limited liability. There also appears to be no consistency generally between the piercing of the corporate veil where there are individuals behind the company and where there are juristic persons who are the shareholders of the subsidiary. This could be due to the fact that in the former group of cases the issue at stake was the potential liability towards third parties, whereas in the latter group of cases, the issue at stake was more the rights of persons which may have been affected, for example whether there had been use of a trade mark or whether a right of first refusal had been triggered. Be that as it may, after the *Cape Pacific* case there should be more consistency and cross referencing of decisions regardless of whether the shareholders are individuals or juristic persons. Although the labour-law cases do not carry much weight because they were mainly equity based, they should not simply be discarded. They could be important for future reform because those cases have shown that greater flexibility is possible.

The King Codes, foreign authors as well as some local writers, have also highlighted the change in the role which companies play in society. Although the prevailing norm is still the shareholder primacy model, this is coming under increasing pressure and this trend can only get stronger, which will result in more pressure on companies and lawmakers. This will have an impact on groups especially in situations like the *Scottish Co-operative* and *Kuwait Asia Bank* cases, and where the court may hold that the holding company has a duty to the stakeholders of the subsidiary.

The aim of this chapter was to investigate to what extent the South African law regarding company groups reflect the conclusions which have been reached in chapters two and three. It was shown in chapter two that the doctrine of limited liability in respect of company groups is historically suspect. In chapter three it was shown that company groups often form single economic units and operate as one entity. It was also shown that

from an economic perspective limited liability cannot be justified as easily where a holding company is present, as where natural persons are the shareholders. This chapter has shown that the South African law regarding groups has generally speaking not heeded this reality. Instead it has in general followed the traditional approach without many questions. Chapter four showed that an alternative system is possible but that there are problems in its implementation. With these conclusions in mind it will be the aim of the next two chapters to investigate whether the South African law regarding groups can be changed to better reflect the conclusions, which were reached in especially chapters two and three, without necessarily abolishing the principle of limited liability. The discussion will focus on the position of involuntary delictual creditors in chapter six and on voluntary creditors of the subsidiary in an insolvency situation in chapter seven. These are the two primary instances under the current South African law where the legitimate claims of creditors against financially weak subsidiaries may be left unsatisfied.

Chapter 6

Delictual liability within company groups

6.1 Introduction

The world is a very different place than what it was in the nineteenth century when limited liability for shareholders was created and adopted.¹ The world has become increasingly globalised with technological advances and increasing global traffic being the order of the day. Multinationals have sprung up everywhere with subsidiary companies scattered across the globe, especially in those places with lax labour legislation and less protection for workers, where poverty forces the hand of governments to accommodate multinationals in their countries, quite often at the expense of the health of the population.²

Also at a domestic level companies, regardless of size, realised the benefits of creating subsidiary companies in the light of the advantages which the doctrine of limited liability affords to them. Limited liability, as mentioned before, shields the shareholders of a company from liability for the debts of the company,³ both contractual and delictual. Limited liability therefore stimulates risk taking. Risk in this context not only means financial risk-taking, which could prejudice (contractual) creditors but also includes the risks associated with the nature of the business. A company may wish to diversify its business and venture into a field which poses significant risks in respect of the safety of workers, the environment and the health of communities who live in the vicinity of the company's premises. Industries in the chemical and mining spheres are especially vulnerable to potential leaks, thereby causing damage to a variety of stakeholders.⁴ Companies therefore want to avoid, or at least restrict, any potential delictual liability from their activities. It therefore makes sense to create subsidiary companies to engage in risky business undertakings to shield the holding company from any potential delictual liability. In the light of the fact that no minimum capital is required to incorporate a

¹ The Limited Liability Act of 1855, para 2.2.1 above.

² The Bhopal disaster in India in the early 1980s for example.

³ Para 2.1 above.

⁴ The recent oil disaster in the Gulf of Mexico is a case in point where not only the environment but also many of the inhabitants of the gulf states of the United States, like Louisiana, have been affected.

(subsidiary) company, the subsidiary can be hopelessly undercapitalised and be funded by means of external funding especially in those cases where the holding company is one with a good credit rating. As will be illustrated below, it often happens that the harm to delictual victims appears much later, after the subsidiary has already closed its doors, which leaves the victims potentially with no recourse since the wrongdoer no longer exists. Even if the wrongdoer is in existence it could be undercapitalised to the extent which makes any litigation futile. Given the nature of the business it can be assumed that the holding company knew or should have known about the harm which the activities of the subsidiary could cause and that this knowledge was an important reason for the creation of the subsidiary.

Creditors of a subsidiary forming part of a group of companies can be involuntary, as opposed to voluntary creditors. These involuntary creditors would include those who have suffered damages due to delicts committed by the company or by one of its employees in circumstances resulting in vicarious liability for the employer company. The first question which will arise in this case is whether the law should spread the liability of the subsidiary company jointly and severally among the companies within the group. Secondly, on what would this liability be based? Should it be statutory or should it be developed by the courts? Thirdly, if there is liability, should the joint and several liability be spread amongst the companies within the group, without making a distinction between voluntary and involuntary creditors?

On the assumption that there should be joint and several liability within the corporate group, it is submitted that the nature of the creditor should be taken into consideration, namely whether the creditor is a voluntary or an involuntary creditor. The natural assumption would probably be that voluntary creditors do not deserve protection since they should have provided for appropriate remedies or securities in their contracts. They could, for example, have obtained suretyships not only from the holding company but also from fellow subsidiaries within the group, or demanded other forms of security. This view, however, is firstly based on the assumption that the parties contracted from equal positions of strength and secondly that the creditor is aware that he is dealing with a

company within a group of companies. There would, under the existing law, be no reason compelling a company within a group to disclose to a creditor that it forms part of a bigger group of companies. There should equally be no reason why, and therefore, no obligation upon a creditor to inform himself whether the company he is dealing with forms part of a group.

Similar arguments could be put forth in the case of involuntary creditors, including juristic persons, who have suffered loss due to the wrongful and culpable acts of a company within a corporate group which could be a delict committed by that company directly or delictual liability in the form of vicarious liability. The automatic response would probably be that these creditors are involuntary and therefore should have a choice as to which entity within the group they will sue, namely the entity with the deepest pockets. These creditors should therefore be able to claim their damages from any entity within the group structure since they did not have the opportunity, like the contractual creditors, to negotiate securities or remedies with other members of the group or securities like mortgages or pledges. On the other hand, should this really be a factor? The cause of the loss could conceivably more often than not be the result of a negligent act by the company instead of a wilful act. Where the act was not wilful, would it be in the public interest to impose joint and several liability on the companies in the group, especially where the harm was caused by an employee of a company within the group and the liability is automatic due to vicarious liability? Already an argument could be made that the company is being “punished” by being held liable for the actions of its employees. Should one then go further to hold even the other companies within the group liable which would be at least two degrees away from the original wrongdoer?

Illustrative of the problems of delictual liability within groups is the case of *Adams v Cape Industries plc*.⁵ The companies involved in this case were Cape plc (Cape), the holding company of a number of subsidiaries, its wholly owned subsidiary, Cape International & Overseas Ltd (CIOL), which in turn wholly owned Cape Asbestos South Africa (Pty) Ltd (CASAP). CASAP wholly owned Egnep (Pty) Ltd. North American

⁵ *Adams v Cape Industries plc* [1990] Ch. 433.

Asbestos Corporation (NAAC) was initially wholly owned by Cape but later transferred to CIOL. Capasco, a prominent roleplayer, was apparently another wholly owned subsidiary of Cape.⁶

The structure of this group was as follows. Cape was the holding company. NAAC was the marketing subsidiary of Cape in the United States of America. Capasco was the marketing subsidiary worldwide. Casap was the subsidiary which owned the mining companies, which initially included Egnep, which owned the asbestos mines which supplied some of the asbestos that was sold into the United States of America.⁷ The shares in CIOL were later sold to Transvaal Consolidated Exploration Co Ltd in 1979. However, it was the mining and marketing of asbestos before 1979 which gave rise to the litigation against Cape and its related companies.⁸ Pittsburg Corning Corporation (PCC) was one of the main customers of Egnep. It owned an asbestos factory in Owentown, Texas which closed in 1972.⁹

In the 1970s a general awareness of the dangers of asbestos took hold. In the Owentown district numerous plaintiffs instituted personal injury claims due to the damages suffered because of their exposure to asbestos dust.¹⁰ Action was instituted against Cape, NAAC and Egnep and later Capasco. The plaintiffs based their claim on the averment that these entities supplied asbestos to the Owentown factory despite the knowledge that asbestos was dangerous and they failed to warn the plaintiffs against the dangers of asbestos.¹¹ Other defendants even included the federal government of the United States of America.

The actions were brought in a Texas Federal Court, and not the state court, under the diversity of citizenship jurisdiction which played an important role in the case. The first action against the defendants was instituted in the Texas Federal Court in Tyler in 1974.¹²

⁶ See 443 where the court *a quo* sets out the facts of the case. The judgment of the court *a quo* and the Court of Appeal are reported under the same citation namely [1990] Ch 433.

⁷ See 443-444.

⁸ 443.

⁹ 444.

¹⁰ 444.

¹¹ 444.

¹² 445.

In due course there was a proliferation of similar actions which caused the presiding judge to adopt a special form of procedure in court. In the meantime Cape, Egnep and Capasco filed papers averring that the Texan court had no jurisdiction over them.

The judge in the case dismissed the motions of the defendants who objected to the jurisdiction of the court although the decision could be appealed. Ultimately the parties were pressured into a settlement by the presiding judge. The number of plaintiffs was 462 and the settlement figure was \$20 million.¹³

After the first “Tyler” set of actions in the Tyler court, new plaintiffs instituted actions on similar grounds to the first set of actions from about 1978. The number was about 206 and the same judge who presided over the first set was assigned to the next action.¹⁴ Cape, Capasco and Egnep refused to participate in the second set of actions against them. They participated in the first set of actions under fear of being exposed to a jury trial and due to the fact that the other defendants were willing to settle. They also expected to win their jurisdictional point, an expectation which did not materialise.¹⁵

Cape realised that there would be more litigation against it as a group. Cape, Capasco and Egnep decided not to participate at all in the second set of actions before the Tyler court and that they would allow default judgment to be taken against them. The three companies had no assets in the United States of America (except shares in NAAC which were without any value) and they were prepared to defend actions in England should there be any application there to enforce the judgments of the Texan court. They reasoned that under English law the courts of the United States had no jurisdiction over them. These decisions were taken at a meeting on 1 November 1977.¹⁶

At the November 1977 meeting it was further resolved that NAAC would be liquidated to avoid the argument that under English law Cape’s interest in NAAC’s United States

¹³ 447.

¹⁴ 447.

¹⁵ 449.

¹⁶ 449.

business sufficed to give the court in Tyler jurisdiction over Cape. The United States, however, would not be abandoned as a market for asbestos. A new company, AMC was incorporated in Liechtenstein and the shares were held by a Liechtenstein attorney as fiduciary for CIOL. Sales of Cape's asbestos into the United States would be done by AMC. A new marketing company in the United States was needed to replace NAAC. The president of the liquidated NAAC, a Mr Morgan, became the president of this new company, Continental Productions Corporation (CPC) at its incorporation in December 1977. Morgan was the sole shareholder. CPC became the agent of AMC for the purpose of selling asbestos in the United States but had no authority to contract on behalf of AMC or any Cape company.¹⁷

Eventually in 1983 default judgment was granted in the Tyler Court against Cape, Eggen and Capasco. The plaintiffs attempted to have the default judgments against the Cape companies enforced in the United Kingdom where Cape, Eggen and Capasco were "resident" and where they had assets.

To enforce their judgment in the United Kingdom the plaintiffs had to show that the Tyler court, under English law, had jurisdiction over Cape and Capasco. Numerous contentions were made in this regard but for the purposes of this dissertation the most important one was that Cape and Capasco were present in Illinois either in January 1974 when the first Tyler actions commenced or in April 1978 to November 1979 when the second set of Tyler actions commenced. The plaintiffs argued that Cape and Capasco were present because NAAC was present in Illinois up to its liquidation in 1978 and CPC was present in Illinois until June 1979. The contention was that the relationship between these companies and Cape and Capasco justified treating the presence of the former in Illinois, for jurisdictional purposes, as the presence of Cape and Capasco in Illinois.¹⁸ This contention was one of the issues in dispute before the English court.

¹⁷ 450.

¹⁸ 455.

The case was decided before Scott J who rejected the averments of the plaintiffs and consequently refused to enforce the Tyler default judgments in England. The plaintiffs took the matter to the Court of Appeal. The focus of the discussion below will be on this judgment. Where relevant, reference will be made to the judgment of Scott J in the court *a quo*.

The Court of Appeal had to grapple with the difficult question of the residence or presence of a corporation in a foreign country. Would the holding of shares in a foreign company, or control over it, suffice to establish residency or presence? The Court of Appeal, with reference to *Okura & Co Ltd v Forsbacka Jernverks Aktiebolag*¹⁹ held that a variety of factors could play a role in determining whether a company had a presence in a foreign jurisdiction.²⁰

To satisfy the requirements to establish a presence in the United States the plaintiff made three submissions. These were firstly that Cape and Capasco were present in the United States because NAAC and CPC acted as their agents, secondly that Cape, Capasco and NAAC and Cape, Capasco and CPC, respectively formed a single economic unit and that the presence of NAAC and CPC respectively in Illinois established the presence of Cape / Capasco in the United States and thirdly that in respect of AMC (the Liechtenstein company) / CPC the corporate veil should be lifted so that CPC's and AMC's presence in the United States of America should be treated as the presence of Cape / Capasco.

The Court of Appeal first dealt with the single economic unit argument of the plaintiffs. It acknowledged the basic principle, with reference to *The Albazero*,²¹ that each company within a group of companies is a separate legal entity which has separate legal rights and liabilities. The Court of Appeal then investigated a number of cases where the single economic argument featured in some form. It first referred to *The Roberta*²² where the relevant court held that the parent company and the subsidiary company were only in name separate entities.

¹⁹ *Okura & Co Ltd v Forsbacka Jernverks Aktiebolag* [1914] 1 KB 715.

²⁰ 527.

²¹ *The Albazero* [1977] AC 774, 807.

²² *The Roberta* (1937) 58 Ll LR.

The Court of Appeal then referred to *Harold Holdworth & Co (Wakefield) Ltd v Caddies*²³ where Lord Reid said the following:

“My Lords, in my judgment this [that each subsidiary within a group is a separate entity] is too technical an argument. This is an agreement *in re mercatoria* and it must be construed in light of the facts and realities of the situation.”²⁴

The Court of Appeal next referred to *Scottish Co-operative Wholesale Society Ltd v Meyer and Another*.²⁵ In his judgment in the *Scottish Co-operative* case, Lord Simonds said the following where there was a group of companies which may have constituted a single economic unit:

“My Lords, it may be that the acts of the society of which complaint is made could not be regarded as conduct of the affairs of the company if the society and the company were bodies wholly independent of each other, competitors in the rayon market, and using against each other such methods of trade warfare as custom permitted. But this is to pursue a false analogy. It is not possible to separate the transactions of the society from those of the company. Every step taken by the latter was determined by the policy of the former.”²⁶

Lord Simonds concluded that the circumstances warranted the court looking at the business realities of the situation and not being confined “to a narrow legalistic view”.²⁷

Arguably the most important case to which the Court of Appeal refers is *DHN Food Distributors Ltd v Tower Hamlets London Borough Council*,²⁸ in which Lord Denning held:

“Third, lifting the corporate veil. We all know that in many respects a group of companies are treated together for the purpose of general accounts, balance sheet, and profit and loss account. They are treated as one concern [...] This is especially the case when a parent company owns all the shares of the subsidiaries - so much so that it can control every movement of the subsidiaries. These subsidiaries are bound hand and foot to the parent company and must do just what the parent company says [...]. This group is virtually the same as a partnership in which all the three companies are partners. They should not be treated separately so as to be defeated on a technical point. They should not be deprived of the

²³ *Harold Holdworth & Co (Wakefield) Ltd v Caddies* [1955] 1 WLR 352.

²⁴ 367.

²⁵ [1959] AC 324, [1958] 3 All ER 66, [1958] 3 WLR 404. See para 5.8 above.

²⁶ 342.

²⁷ 343.

²⁸ [1976] 1 WLR 852. See para 3.10 above for the facts of this case.

compensation which should justly be payable for disturbance. The three companies should, for present purposes, be treated as one, and the parent company D.H.N. should be treated as that one.”²⁹

In his concurring judgment in the *DHN* case, Goff LJ held:

“[T]his is a case in which one is entitled to look at the realities of the situation and to pierce the corporate veil. I wish to safeguard myself by saying that so far as this ground is concerned, I am relying on the facts of this particular case. I would not at this juncture accept that in every case where one has a group of companies one is entitled to pierce the veil, but in this case the two subsidiaries were both wholly owned; further, they had no separate business operations whatsoever; thirdly, in my judgment, the nature of the question involved is highly relevant, namely, whether the owners of this business have been disturbed in their possession and enjoyment of it.”³⁰

The Court of Appeal next referred to *Revlon Inc v Cripps & Lee Ltd*³¹ where the question to be decided was whether the goods in question were “connected in the course of trade with the proprietor [...] of the trade mark” within the meaning of the relevant trade mark legislation in the United Kingdom. The owner of the trade mark was Revlon Suisse SA which was a subsidiary of Revlon Inc. Lord Buckley held the following:

“Since, however, all the relevant companies are wholly-owned subsidiaries of Revlon, it is undoubted that the mark is, albeit remotely, an asset of Revlon and its exploitation is for the ultimate benefit of no one but Revlon. It therefore seems to me to be realistic and wholly justifiable to regard Suisse as holding the mark at the disposal of Revlon and for Revlon's benefit. The mark is an asset of the Revlon group of companies regarded as a whole, which all belongs to Revlon. This view does not, in my opinion, constitute what is sometimes called 'piercing the corporate veil'; it recognises the legal and factual position resulting from the mutual relationship of the various companies.”³²

The Court of Appeal was requested by the plaintiffs to recognise the commercial reality of the Cape group of companies in the light of the abovementioned judgments.

To answer the question of residence in the United States, the Court of Appeal recognised that it was bound to investigate the relationship between the holding company and the subsidiary which conducted business in the country where residency of the holding company was being investigated. It was especially important to determine whether there

²⁹ 860 of the actual case and 534 of the Court of Appeal judgment in *Adams*.

³⁰ 861 of the actual case and 534 of the Court of Appeal judgment in *Adams*.

³¹ *Revlon Inc v Cripps & Lee Ltd* [1980] F.S.R. 85.

³² 105 of the actual case and 535 of the Court of Appeal case in *Adams*.

was some form of agency relationship between the holding company and the relevant subsidiary. The Court of Appeal, however, warned that there was not a presumption of agency and there was no presumption that the subsidiary was the alter ego of the holding company.³³ The Court of Appeal accepted the following basic premise in cases like these:

“If a company chooses to arrange the affairs of its group in such a way that the business carried on in a particular foreign country is the business of its subsidiary and not its own, it is, in our judgment, entitled to do so. Neither in this class of case nor in any other class of case is it open to this court to disregard the principle of *Salomon v. A. Salomon & Co. Ltd.* [1897] A.C. 22 merely because it considers it just so to do.”³⁴

The plaintiffs argued before the Court of Appeal that Cape conducted a single integrated mining division and ignored corporate law formalities which existed between members of a group of companies when one viewed the manner in which Cape carried on its business. The Court of Appeal, however, recognised that it was in the very nature of a holding company and its subsidiary that the holding company was in a position to exercise total control over the general direction of the subsidiary and that this did not imply that the group was one single unit.³⁵ The plaintiffs averred that the control which was exercised was not general control but the actual day to day running of the relevant subsidiary, NAAC.

The Court of Appeal understood the averment in the light of the set up of the Cape group of companies. It also appreciated why the *DHN*³⁶ approach of a single partnership with various partners seemed attractive *in casu*. However, the Court of Appeal agreed with the following statement in *Bank of Tokyo Ltd v Karoon*:³⁷

“[Counsel] suggested beguilingly that it would be technical for us to distinguish between parent and subsidiary company in this context; economically, he said, they were one. But we are concerned not with economics but with law. The distinction between the two is, in law, fundamental and cannot here be bridged.”³⁸

³³ 537.

³⁴ 537.

³⁵ 538.

³⁶ Above.

³⁷ *Bank of Tokyo Ltd v Karoon* [1987] AC 45 46.

³⁸ 538.

The Court of Appeal rejected the single economic entity argument in respect of NAAC and CPC despite the level of control which Cape exercised over the entities, without providing any concrete reasons,³⁹ except relying on a broad policy reasoning which was not necessarily convincing in the light of the facts at hand.

The Court of Appeal had to deal next with the piercing of the corporate veil point. To succeed with this argument the plaintiffs had to prove that the corporate form used in the Cape group was merely a façade. The plaintiffs argued that the arrangements and the motives behind the arrangements within the Cape group showed that the whole corporate form was a façade. This was especially so in the light of the fact that the whole restructuring within the Cape group only took place after the first set of Tyler cases and before the institution of the second set of Tyler cases. On the facts the Court of Appeal, however, concluded that it was the intention of Cape to continue to sell asbestos from the South African subsidiaries in the United States of America but simultaneously to reduce the appearance of any involvement in such sales by Cape or any of its subsidiaries. Cape furthermore intended to reduce any risk, by lawful means, which it or any of its subsidiaries could face for liability in the United States of America or possible subjection to the jurisdiction of the United States courts and a consequential default judgment of such a court which could be enforced in the courts of the United Kingdom.

The question that the Court of Appeal had to answer was whether the arrangements of Cape, namely the liquidation of NAAC and the incorporation of AMC and CPC were merely a façade to justify the piercing of the corporate veil so as that CPC's and AMC's presence in the United States of America should be treated as the presence of Cape / Capasco.

The Court of Appeal then investigated the case law in respect of piercing. It referred to *Merchandise Transport Ltd v British Transport Commission*,⁴⁰ *Jones v Lipman*,⁴¹ *Wallersteiner v Moir*⁴² and *Littlewoods Mail Order Stores Ltd v Inland Revenue*

³⁹ 538-539.

⁴⁰ *Merchandise Transport Ltd v British Transport Commission* [1962] 2 QB 173.

⁴¹ *Jones v Lipman* [1962] 1 WLR 832.

⁴² *Wallersteiner v Moir* [1974] 1 WLR 991.

*Commissioners*⁴³ but came to the conclusion that these cases provided little guidance as to the principles which should guide a court in determining whether or not the arrangements within a group of companies constituted a sham.⁴⁴

The Court of Appeal looked at the position of AMC⁴⁵ and concluded that it was a façade and merely Cape in disguise. However, since AMC was not conducting business in the United States of America, it could not assist the plaintiffs to establish that Cape / Capasco had a presence in the United States of America.

It was important for the plaintiffs to establish that CPC was also a sham to establish a presence of Cape / Capasco in the United States since CPC was clearly conducting business in the United States. The shares of CPC it will be recalled were held by Morgan, who had been the president of the liquidated NAAC. The plaintiffs argued that a court will pierce the corporate veil where a defendant, by making use of a corporate structure, attempts to evade, firstly limitations placed on his conduct by law, secondly to evade such rights of relief against him as third parties already possess and thirdly to evade such rights of relief which third parties may obtain in future.⁴⁶ *In casu* the issue was whether the court could pierce the veil on the third of these grounds since there were no vested rights when Cape Industries re-organised its operations in the United States. The court held that the law allows a person to arrange his/its affairs in such manner to avoid the risk which was foreseen in this case.⁴⁷

The Court of Appeal concluded on this point that Cape entered into the restructuring of its business in the United States due to an apprehension that they could be held to be present in the United States (arising after the first set of Tyler actions which were settled) and therefore that they should restructure their operations so as not to be present in the

⁴³ *Littlewoods Mail Order Stores Ltd v Inland Revenue Commissioners* [1969] 1 WLR 1241.

⁴⁴ 543.

⁴⁵ The Liechtenstein company formed as a result of the November 1977 agreement.

⁴⁶ 544.

⁴⁷ 544.

United States. The Court of Appeal therefore also rejected the piercing of the veil argument.⁴⁸

The third ground upon which the plaintiffs relied to show that Cape and Capasco had a presence in the United States of America was that since NAAC and CPC acted as agents for Cape and Capasco, as such they conducted the business of Cape in the United States.⁴⁹ In the court *a quo* Scott J rejected this submission and held that the business which NAAC conducted was its own business and not that of Cape.

The Court of Appeal agreed with Scott J and held that the business that NAAC conducted was its own. It based its opinion on certain factual circumstances.⁵⁰ In the first place NAAC was the lessee of its business premises and paid its own rent. It also owned office furniture and employed its own employees for whom it also had a pension scheme.

It secondly also often acted independently of Cape in the sense that it did not buy all its asbestos from Cape. It also made purchases from the government of the United States or from Egnep and Casap and sold this asbestos to customers in the United States. Such purchases represented about 25% of the business of NAAC. It also bought asbestos from Japan and sold this to its customers in the United States. Although the majority of the business of NAAC was derived from Cape, the Court of Appeal still held that the other non-Cape business of NAAC was not trivial.

Thirdly NAAC rented warehouses and paid for this out of its own pocket to store the asbestos which it had bought from the United States government or from Egnep or Casap.

NAAC fourthly earned profits and paid tax in the United States on these profits. It also had its own creditors and debtors. Dividends were paid to its shareholder, Cape, after resolutions were duly passed by the board of directors of NAAC.

⁴⁸ 544.

⁴⁹ 545.

⁵⁰ 545-548.

The Court of Appeal therefore held on the above facts that NAAC conducted its own business in the United States. The question was, however, also whether the functions which it performed on behalf of Cape / Capasco could be construed as conducting the business of those two entities. These functions were generally marketing and after sales follow ups with customers of Cape / Capasco. It was paid commission for these services. According to the Court of Appeal there was no evidence that NAAC reserved any part of its offices or staff exclusively for its agency functions on behalf of Cape / Capasco.⁵¹

The Court of Appeal did not deny that the services which NAAC rendered for Cape / Capasco were very important for the business of the Cape group in the United States. However, NAAC did not have a *carte blanche* authority in respect of its agency and operated under strict limitations. NAAC never effected any contract which would bind Cape / Capasco to a purchaser of asbestos. The contractual parties in any sale that NAAC concluded were NAAC and the relevant third party purchaser or seller. The Court of Appeal therefore held that the business which NAAC conducted was its own and not that of Cape or Capasco. Cape / Capasco were therefore never present in the United States through NAAC.⁵²

The last question which needed to be answered was whether Cape / Capasco were present through the presence of CPC. The Court of Appeal held that, like with NAAC, the business was its, CPC's, own.⁵³ The functions which it performed for Cape / Capasco were similar to the functions which NAAC performed for those two entities. CPC had no authority to bind Cape / Capasco to any contractual obligation and the contracts it entered into were its own. Cape / Capasco were therefore according to the Court of Appeal not present in the United States through CPC at any stage.

6.2 The judicial approach to company group liability

In the light of the *Adams v Cape Industries plc* case the next question to investigate concerns the attitude of the judiciary to liability within company groups. On the

⁵¹ 546.

⁵² 547.

⁵³ 548-549.

assumption that the law needs to address the problem of delictual liability within groups, two options are available. The first option is to consider the doctrine of the piercing of the corporate veil and to determine whether this could be an effective solution. The law of the United States of America, and in less detail, that of Australia will be investigated in order to determine whether the South African law can learn anything from these jurisdictions. The second option is to investigate the possibility of abolishing the principle of limited liability in respect of delicts committed by members of a company group and to determine whether this would be a sound approach from a policy perspective.

6.2.1 The piercing of the corporate veil doctrine in the United States of America

Initially the American courts provided little guidance as to the circumstances where the corporate veil within company groups would be pierced. This is illustrated by *United States v Milwaukee Refrigerator Transit Co*⁵⁴ where the court held that the separate juristic personality would be ignored where the “entity is used to defeat public convenience, justify wrong, protect fraud, or defend crime.”⁵⁵ According to Blumberg the doctrine of piercing the veil within the context of company groups evolved in time as a “three factor ‘instrumentality’ and ‘alter ego’ doctrines for piercing the veil.”⁵⁶ The piercing of the corporate veil or alter ego case law is based, therefore, upon three factors. The instrumentality mechanism is used interchangeably with the alter ego mechanism and both consist of three essential features or factors; firstly the lack of an independent existence of the subsidiary, secondly the abuse of the corporate form to accomplish a fraudulent, inequitable, or wrongful purpose and, thirdly the causal relationship to the plaintiff’s loss.⁵⁷

In contrast to the three-factor case law on the piercing of the corporate veil, jurisprudence developed which only focused on a single factor to determine whether the separate

⁵⁴ Above.

⁵⁵ See also Blumberg *Blumberg on Corporate Groups* Volume 1 2ed (2003) 10-6.

⁵⁶ Blumberg *Corporate Groups* 10-6.

⁵⁷ Blumberg *Corporate Groups* 10-8.

corporate personality should be disregarded or not.⁵⁸ This jurisprudence can be divided into the doctrines of “lack of separate existence of the subsidiary” and “use of the subsidiary for fraudulent, inequitable or wrongful purposes.”⁵⁹

With that brief overview of the piercing of the veil theories in the United States of America it is necessary to delve deeper below the surface and investigate whether the United States law on piercing the corporate veil in the context of corporate group offers any assistance and guidance to the South African courts.

According to Blumberg the American judiciary either uses the instrumentality test or the alter ego test, or alternatively a single-factor test to determine whether the corporate veil should be pierced.⁶⁰ As mentioned above, three factors need to be proved before an American court will pierce the veil between the holding company and subsidiary company in terms of the instrumentality test and alter ego test.

6.2.1.1 *The instrumentality test*

Powell was responsible for formulating the instrumentality doctrine.⁶¹ Powell lists three elements for the application of the instrumentality doctrine. The first element is control. The mere existence of control is not sufficient. The holding company should exercise *de facto* control over the subsidiary.⁶² Control according to Powell involves two aspects, namely the subsidiary has first of all become “a mere instrumentality or puppet”⁶³ of the holding company. Nevertheless the assets and business of the subsidiary have *prima facie* remained distinct from those of the holding company.⁶⁴ The second aspect involves that the affairs of the holding company and the subsidiary company have become so

⁵⁸ Blumberg *Corporate Groups* 10-8.

⁵⁹ Blumberg *Corporate Groups* 10-8 – 10-10.

⁶⁰ Blumberg *Corporate Groups* 11-3.

⁶¹ Powell *Parent and Subsidiary Corporations, Liability of a parent corporation for the obligations of its subsidiary* 1931.

⁶² Powell *Liability of a parent corporation* 3, 4-5.

⁶³ Powell *Liability of a parent corporation* 7.

⁶⁴ Powell *Liability of a parent corporation* 7.

intertwined and confused that it is not practically possible to separate them in a particular transaction.⁶⁵

The court in *United States v Reading Co*⁶⁶ formulated the first element in the following terms where a holding company holds the majority shares in the subsidiary:

“where such ownership of stock is resorted to, not for the purpose of participating in the affairs of the [subsidiary] corporation, [...] but for the purpose of making it a mere agent, *or instrumentality* [...], the courts will look through the forms to the realities of the relation between the companies.”⁶⁷

The second element of the control test was formulated in *United States v Lehigh*.⁶⁸ The court held that:

“[T]he use of such stock ownership (by the holding company) in substance for the purpose of destroying the entity of a producing, etc, corporation, and of commingling its affairs in administration with the affairs of the railroad company, so as to make the two corporations virtually one.”⁶⁹

From both cases it is apparent that there was abusive control although it differed in degree. In the *Reading* case the businesses of the holding company and subsidiary still had a semblance of independence but in the *Lehigh* case the two businesses were completely intertwined and formed one entity for all practical purposes.⁷⁰

According to Powell it is a question of fact and degree whether the holding company exercises so much influence over the subsidiary company that the subsidiary company becomes a mere instrument of the holding company. He recognises that it would be impossible to set a *numerus clausus* of instances where the control element of the instrumentality test will be satisfied, but states that there are certain common denominators which could indicate the control required to satisfy the first requirement of

⁶⁵ Powell *Liability of a parent corporation* 7.

⁶⁶ Above.

⁶⁷ 62, my italics.

⁶⁸ Above.

⁶⁹ 274.

⁷⁰ Powell *Liability of a parent corporation* 8.

the instrumentality test. These common denominators or *indiciae*, bearing in mind that they have to be present in combination with one another and not in isolation, are:

- “(a) The parent company owns all the or most of the capital stock of the subsidiary.
- (b) The parent and subsidiary corporations have common directors or officers.
- (c) The parent corporation finances the subsidiary.
- (d) The parent corporation subscribes to all the capital stock of the subsidiary or otherwise causes its incorporation.
- (e) The subsidiary has grossly inadequate capital.
- (f) The parent corporation pays the salaries and other expenses or losses of the subsidiary.
- (g) The subsidiary has substantially no business except with the parent corporation or no assets except those conveyed to it by the parent corporation.
- (h) In the papers of the parent corporation or in the statements of its officers, the subsidiary is described as a department or division of the parent corporation, or its business or financial responsibility is referred to as the parent corporation’s own.
- (i) The parent corporation uses the property of the subsidiary as its own.
- (j) The directors or executives of the subsidiary do not act independently in the interest of the subsidiary but take their orders from the parent corporation in the latter’s interest.
- (k) The formal legal requirements of the subsidiary are not observed.”⁷¹

The second element of the instrumentality doctrine is the holding company’s fraud or wrongful behaviour *vis-à-vis* the injured party.⁷² Powell refers to *United States v Milwaukee Refrigerator Transit Co*⁷³ where the court held that separate juristic personalities of a holding company and its subsidiary will be ignored where they are used to defraud a person.⁷⁴

Powell lists a number of grounds which the courts have held to constitute fraud. Fraud should also be understood in broad terms. The grounds are; fraud, the violation of legislation, stripping the assets of the subsidiary company, misrepresentation, estoppel,⁷⁵

⁷¹ Powell *Liability of a parent corporation* 8.

⁷² Powell *Liability of a parent corporation* 40.

⁷³ Above.

⁷⁴ See Powell *Liability of a parent corporation* 40.

⁷⁵ *Lehigh Valley Railroad Company v Dupont* and *Lehigh Valley Railroad Company v Delachesa* above. This is, however, not estoppel in the technical common-law sense according to Powell. Where the holding company represents that it is responsible for its subsidiary company, that by itself will be sufficient to hold the holding company liable according to case law of the era. See further Powell 66.

torts and other cases of wrong or injustice.⁷⁶ The third element of the instrumentality doctrine is the requirement that the plaintiff must have suffered damages or injury in a way which was unjust.⁷⁷

A case in point to illustrate the application of the instrumentality test by a number of the United States courts is *Lowendahl v Baltimore & Ohio Railroad*.⁷⁸ The court restated Powell's formulation of the instrumentality doctrine in slightly different terms, namely

“Restating the instrumentality rule, we may say that in any case, except express agency, estoppel, or direct tort, three elements must be proved:

‘(1) Control, not mere majority or complete stock control, but complete domination, not only of finances, but of policy and business practice in respect to the transaction attacked so that the corporate entity as to this transaction had at the time no separate mind, will or existence of its own; and

(2) Such control must have been used by the defendant to commit fraud or wrong, to perpetrate the violation of a statutory or other positive legal duty, or a dishonest and unjust act in contravention of plaintiff's legal rights; and

(3) The aforesaid control and breach of duty must proximately cause the injury or unjust loss complained of.’”⁷⁹

6.2.1.2 *The alter ego doctrine*

The alter ego doctrine developed adjacent to the instrumentality doctrine in a number of states in the United States including California, Delaware and New Hampshire.⁸⁰ According to Blumberg the doctrine differs only in form from the instrumentality doctrine and is substantively the same as the instrumentality doctrine.⁸¹

In *Webber v Inland Empire Investment Inc*⁸² Hyatt Land Development Corporation sold four pieces of land to Forecast Mortgage Corporation. Forecast Mortgage Corporation paid by means of a note which it had executed in the amount of \$754 000,00 in favour of

⁷⁶ Powell *Liability of a parent corporation* 54.

⁷⁷ Powell *Liability of a parent corporation* 82.

⁷⁸ *Lowendahl v Baltimore & Ohio Railroad* 247 AD 144, 287 NYS 62, 76 (1st Dept) and affirmed in 272 NY 360, 6 NE 2nd 56 (1936).

⁷⁹ 157.

⁸⁰ Blumberg *Corporate Groups* 11-5.

⁸¹ Blumberg *Corporate Groups* 11-5.

⁸² *Webber v Inland Empire Investment Inc* 74 Cal.App.4th 884, 88 Cal.Rptr.2d 594, (1999).

Hyatt Land Development Corporation. Security for the amount was provided by means of a deed of trust over one of the pieces of land. Webber took cession of the note and the deed of trust.

The balance of the purchase price for the four pieces of land was provided by means of a loan by Sanwa Bank which received security in the form of a deed of trust over all four pieces of land. The deed of trust of Sanwa Bank was executed before the Hyatt deed of trust and the *prior in tempore potior in iure* principle was applied.

In due course the properties were transferred from Forecast Mortgage Corporation to Forecast Corporation which in turn transferred the properties to All Cities Mini-Storage. Forecast Mortgage subsequently failed to make any payments on the note which had been issued to Hyatt, who in turn had ceded it to Webber, who then commenced with foreclosure proceedings.

Although the parties agreed that Forecast Mortgage Corporation had the financial ability to pay off the Hyatt note in August 1992, it decided not to do so. Instead, Forecast's owner, Mr. Previti, decided to (i) transfer title to the property from Forecast Corporation to another corporation he controlled, All Cities Mini-Storage; (ii) use another corporation he controlled, Inland Empire Investments, to purchase the note, a note which the court does not define, from Sanwa Bank; (iii) have Forecast Mortgage default on the note, and (iv) then have Inland Empire foreclose on the property, thus eliminating Mr. Webber's junior security on the fourth piece of property. The trial court subsequently characterised these transactions as a "sham foreclosure".

Following this course of action, Inland bought the note from Sanwa, and the note and deed of trust were assigned to Inland. Mr. Webber decided not to pursue his foreclosure action, and Inland then proceeded with its own foreclosure action against All Cities, purchasing the property at a foreclosure sale in January 1993. Due to the foreclosure of the senior lien, Mr. Webber's junior lien was extinguished. The end result was that Mr. Webber lost his junior lien in the amount of \$754 000,00 plus interest.

The trial court found that Mr. Previti was the owner of all or at least half of the shares of Forecast Mortgage, Forecast Corporation, Inland Empire Investments, All Cities Mini-Storage, Forecast Development, and Forecast Homes of Northern California. It therefore found that Inland, as dominated and controlled by Mr. Previti, was acting as the alter ego of Forecast Mortgage in the transactions under discussion.

The court referred to *Communist Party v 522 Valencia Inc*⁸³ where the court stated that ordinarily a corporation is regarded as a legal entity separate and distinct from its shareholders and directors. Under the alter ego doctrine, however, where a corporation is used by an individual or by another corporation, to perpetrate fraud, circumvent a statute, or accomplish some other wrongful or inequitable purpose, a court may disregard the corporate entity and treat the corporation's acts as if they were done by the persons actually controlling the corporation.

The alter ego doctrine requires two elements to be satisfied. The court in *Inland Empire* couches the doctrine and its requirements in the following terms:

“[That firstly] there is such a unity of interest and ownership between the corporation and the individual or organization controlling it that their separate personalities no longer exist, and [secondly] failure to disregard the corporate entity would sanction a fraud or promote injustice. The doctrine is applicable where some innocent party attacks the corporate form as an injury to that party's interests. The issue is not so much whether the corporate entity should be disregarded for all purposes or whether its very purpose was to defraud the innocent party, as it is whether in the particular case presented, justice and equity can best be accomplished and fraud and unfairness defeated by disregarding the distinct entity of the corporate form. Nevertheless, persons who themselves control a corporation, who have used the corporate form of doing business for their benefit, who have dealt with and treated the corporation as a separate entity, or who have otherwise by their actions expressly or impliedly recognized its corporate existence, may be estopped to deny the corporation's separate legal existence. Parties who determine to avail themselves of the right to do business by means of the establishment of a corporate entity must assume the burdens thereof as well as the privileges. The *alter ego* doctrine is applied to avoid inequitable results, not to eliminate the consequences of corporate operations. Thus, alter ego is

⁸³ *Communist Party v 522 Valencia Inc* (1995) 35 California Appeal Court 4th Circuit 980, 41 California Reporter 2nd 618.

used to prevent a corporation from using its statutory separate corporate form as a shield from liability only where to recognize its corporate status would defeat the rights and equities of third parties; it is not a doctrine that allows the persons who actually control the corporation to disregard the corporate form. In other words, alter ego is a limited doctrine, invoked only where recognition of the corporate form would work an injustice to a third person.”⁸⁴

From the above it is clear that the court looks at abuse of the corporate form in specific cases and not generally.⁸⁵ It is not required that the corporate form has been permanently abused before a court will pierce the corporate veil. According to Blumberg the (Federal) California Courts of Appeals for the Tenth and Eleventh Circuits formulate the doctrine in different terms without the introduction of any new elements.⁸⁶

In *National Labor Relations Board v Greater Kansas City Roofing*⁸⁷ the Court of Appeals formulated the requirements for the alter ego doctrine as follows:

“In accordance with prior Tenth Circuit precedent and after careful consideration of the analysis of this issue offered by our sister courts, we conclude that the federal common law doctrine of piercing the corporate veil under an alter ego theory can best be described by the following two-part test: (i) was there such unity of interest and lack of respect given to the separate identity of the corporation by its shareholders that the personalities and assets of the corporation and the individual are indistinct, and (ii) would adherence to the corporate fiction sanction a fraud, promote injustice, or lead to an evasion of legal obligations.”⁸⁸

In *National Labor Relations Board v West Dixie Enterprises Inc*⁸⁹ the Court of Appeals confirmed the decision in the *Greater Kansas* case and held that:

“the corporate veil may be pierced when: (1) there is such unity of interest, and lack of respect given to the separate identity of the corporation by its shareholders, that the personalities and assets of the corporation and the individuals are indistinct, and (2) adherence to the corporate form would sanction a fraud, promote injustice, or lead to an evasion of legal obligations.”⁹⁰

⁸⁴ 604.

⁸⁵ See *Cape Pacific v Lubner Controlling Investments* in chapter 2 above.

⁸⁶ Blumberg *Corporate Groups* 11-6.

⁸⁷ *National Labour Relations Board v Greater Kansas City Roofing* 2 F.3d 1047 (CA 10th Circuit 1993).

⁸⁸ 1052.

⁸⁹ *National Labour Relations Board v West Dixie Enterprises Inc* 190 F.3d 1911 (CA 11th Circuit 1999).

⁹⁰ 1194.

From the quoted cases it would appear that the second requirement is a very broad one since it ranges from fraud to the promotion of injustice. It would, however, appear that “fraud” does not mean fraud at the incorporation of the subsidiary company but fraud in respect of a particular action committed by the holding company.⁹¹

6.2.1.3 Evaluation of the alter ego and instrumentality doctrines

When one compares the instrumentality doctrine to the alter ego doctrine the two doctrines do not seem to differ fundamentally. The control element of the instrumentality doctrine in essence is reflected by the unity of interests element of the alter ego doctrine and the second element of both doctrines contains fraud, inequity or unjust behaviour. The third element of the instrumentality doctrine could in essence be ignored since any claim for damages requires a causal link between an action and the damages or loss suffered by a plaintiff. It is therefore not a unique requirement.

The first element of both doctrines could be summarised as the subsidiary company not enjoying a separate existence, either due to the complete or excessive control by the holding company or due to the ignorance or disregard of “corporate formalities and absence of *indiciae* of separate existence.”⁹²

The first requirement of both doctrines is not particularly specific since it is not quite clear what “excessive” control or “lack of separate existence” means. This requirement therefore becomes one that can only be ascertained on the facts at hand and not one that could be ascertained *a priori*. The nature of the relationship between a holding company and a subsidiary company pre-supposes control. The holding company will either have all or the majority of the shares in the subsidiary company or be able to appoint and dismiss the directors who have the majority vote at board meetings of the subsidiary companies. It is after all the whole purpose of being a majority shareholder to control the company and determine its direction and policies.

⁹¹ See Blumberg *Corporate Groups* 11-7.

⁹² Blumberg *Corporate Groups* 11-9.

Blumberg divides the various states of control into four classes of relationship.⁹³ The first and second forms of control are not contentious. The first form is the ordinary control which would enable a holding company to appoint or dismiss the majority of directors of the subsidiary company or to be able to exercise control over the direction and policies of the subsidiary company.

The second form of control according to Blumberg is one that is consistent and in line with, or generally viewed as appropriate, in the United States corporate environment. This would include having most or even all of the directors of the holding company serving on the board of directors of the subsidiary company. This would also include the power of the holding company to set general policies for the subsidiary company, the power of the holding company to veto the undertaking of large capital projects by the subsidiary company and to provide blanket cover in respect of pension and other benefits across the board for companies within a group. Blumberg states that most courts require more than the aforementioned elements before control could be viewed as excessive and resulting in a subsidiary company not enjoying a separate existence.⁹⁴

The most contentious class of relationship, according to Blumberg, is the third class where there is “[i]ntrusion into the decision making of the subsidiary going beyond customary and appropriate levels, but not extending as far as control over day-to-day decisions.”⁹⁵ It is obvious that this class of relationships would imply a grey area where the particular facts of each case would determine the outcome of each matter and that there can be no hard and fast rule to act as a reliable guide through the uncertainty.

In the fourth class of controlling relationships the holding company exercises daily control over the management of the subsidiary company which according to Blumberg is almost universally accepted by the United States courts as being sufficient to justify the piercing of the corporate veil.⁹⁶

⁹³ Blumberg *Corporate Groups* 11-10.

⁹⁴ Blumberg *Corporate Groups* 11-10 and 11-11.

⁹⁵ Blumberg *Corporate Groups* 11-11.

⁹⁶ Blumberg *Corporate Groups* 11-12.

Apart from control, the other issue at hand with the first element is the one of the separate existence of the subsidiary company. The United States courts will ask whether the subsidiary company has its own business premises, its own business infrastructure, its own employees and bank accounts, for example.⁹⁷ Blumberg further states that proof of excessive control would suffice to satisfy the first requirement and that proof that there is no separate existence is not required.⁹⁸ Ultimately proof of either one will result in showing that there is not an independent subsidiary company.

The second requirement of both the instrumentality and alter ego doctrines is the “existence of morally culpable conduct” by an alleged wrongdoer.⁹⁹ Actual fraud is not required. In *National Labor Relations Board v West Dixie Enterprises Inc*¹⁰⁰ the Court of Appeals for the Eleventh Circuit held that where a shareholder appropriates the funds of a company for personal use, such conduct would satisfy the second requirement of the two piercing doctrines. In *Oddenino & Gaule v United Financial Group of Illinois*¹⁰¹ the Federal Court of Appeals for the Ninth Circuit held that:

“The appellants fail, however, to satisfy the second prerequisite of alter ego liability, that an inequitable result will follow ‘if the acts are treated as those of the corporation alone.’ The existence of an unsatisfied creditor does not, by itself, create an inequitable result. Rather, the purpose of the alter ego doctrine is to afford such creditors protection *where some conduct amounting to bad faith* makes it inequitable ... for the equitable owner of a corporation to hide behind its corporate veil. An inequitable result arises when the existence of an unsatisfied creditor is coupled with an abuse of the corporate form, such as a misrepresentation of the corporate structure to creditors or undercapitalization so severe that the capital input is insufficient to meet obligations that could reasonably be expected to arise in the normal course of business.”¹⁰²

In *RRX Industries Inc v Lab-Con Inc*¹⁰³ the Court of Appeals for the Ninth Circuit held that:

⁹⁷ Blumberg *Corporate Groups* 11-14.

⁹⁸ Blumberg *Corporate Groups* 11-14.

⁹⁹ Blumberg *Corporate Groups* 11-15.

¹⁰⁰ Above.

¹⁰¹ *Oddenino & Gaule v United Financial Group of Illinois* 201 F.3d 444 CA 9 (Cal.),1999.

¹⁰² 444, my italics.

¹⁰³ *RRX Industries Inc v Lab-Con Inc* 772 F.2d 543, CA 9 (Cal.),1985.

“Appellants argue that the district court erroneously imposed liability because it did not find that Kelly acted in bad faith. *A finding of bad faith, however, is not a prerequisite to the application of the alter ego doctrine under California law.*”¹⁰⁴

Although the *RRX Industries* case precedes the *Oddenino* decision the latter decision does not explicitly reject the *RRX* decision in respect of the question of bad faith. It can therefore be accepted that bad faith is not a requirement that has to be met to satisfy the second element of the respective piercing doctrines.¹⁰⁵

Blumberg states that the conduct which has been required by the courts to satisfy the second element of the respective doctrines is “conduct beyond the pale of acceptable business practices that has a detrimental impact on creditors for which the latter cannot reasonably be expected to have bargained.”¹⁰⁶ Blumberg refers to cases which constituted such conduct, namely instances where the assets of the holding company and subsidiary company were intermingled, instances where the holding company stripped the subsidiary company of its assets and instances where the holding company conducted the business of the subsidiary without the subsidiary having any assets or was undercapitalised by the holding company.¹⁰⁷

The third element of the respective doctrines does not need to be discussed since it is self evident that a person who feels wronged should be able to show that the conduct of the holding company caused him loss and that there is a causal link between the wrongful conduct and his loss.

As mentioned before the two doctrines for the piercing of the corporate veil in the United States law do not appear to differ significantly from one another. In *William Passalacqua Builders Inc v Resnick Developers South Inc*¹⁰⁸ the Court of Appeals for the Second Circuit had to decide on an appeal where the plaintiff brought his action based upon both

¹⁰⁴ 546, my italics.

¹⁰⁵ See also Blumberg *Corporate Groups* 11-17.

¹⁰⁶ Blumberg *Corporate Groups* 11-17.

¹⁰⁷ Blumberg *Corporate Groups* 11-18 and 11-19.

¹⁰⁸ *William Passalacqua Builders Inc v Resnick Developers South Inc* 933 F. 2d 131 CA 2 (NY) 1991.

doctrines under separate counts. The court as background set out the history of the piercing of the corporate veil and stated that the doctrine is based in law and equity.¹⁰⁹

The court then held that:

“[T]he three-factor rule in New York and the alter ego theory sued on in this case are indistinguishable, do not lead to different results, and should be treated as interchangeable.”¹¹⁰

Certain courts have also looked at a checklist of factors to guide them through the evidentiary confusion to determine whether the corporate veil should be pierced or not. In *Associated Vendors Inc v Oakland Meat Company*¹¹¹ the court said the following:

“A review of the cases which have discussed the problem discloses the consideration of a variety of factors which were pertinent to the trial court's determination under the particular circumstances of each case. Among these are the following: Commingling of funds and other assets, failure to segregate funds of the separate entities, and the unauthorized diversion of corporate funds or assets to other than corporate uses; treatment by an individual of the assets of the corporation as his own;¹¹² the failure to obtain authority to issue stock or to subscribe to or issue the same;¹¹³ the holding out by an individual that he is personally liable for the debts of the corporation;¹¹⁴ the failure to maintain minutes or adequate corporate records, and the confusion of the records of the separate entities;¹¹⁵ the identical equitable ownership in the two entities; the identification of the equitable owners thereof with the domination and control of the two entities; identification of the directors and officers of the two entities in the responsible supervision and management; sole ownership of all of the stock in a corporation by one individual or the members of a family;¹¹⁶ the

¹⁰⁹ 135.

¹¹⁰ 138.

¹¹¹ *Associated Vendors Inc v Oakland Meat Company* 210 Cal.App.2d 825, 26 Cal.Rptr. 806, Cal.App. 1963. In the original judgment the cases, as authority, were included in the text of the judgment. The writer has, however, included the cases in footnotes to promote readability. The writer also read each of the cases cited to verify that they are indeed authority for the propositions/statements made by the court in *Associated Vendors* in its judgment.

¹¹² The court in the *Oakland Meat Company* case refers to: *Minton v. Cavaney*, 56 Cal.2d 576, 15 Cal.Rptr. 641, 364 P.2d 473; *Thomson v. L. C. Roney & Co.*, 112 Cal.App.2d 420, 246 P.2d 1017; *Riddle v. Leuschner*, 51 Cal.2d 574, 335 P.2d 107.

¹¹³ *Automotriz etc. De California S. A. De C. V. v. Resnick*, 47 Cal.2d 792, 306 P.2d 1, 63 A.L.R.2d 1042; *Wheeler v. Superior Mortgage Co.*, 196 Cal.App.2d 822, 17 Cal.Rptr. 291; *Marr v. Postal Union Life Ins. Co.*, 40 Cal.App.2d 673, 105 P.2d 649; *Claremont Press Publishing Co. v. Barksdale*, 187 Cal.App.2d 813, 10 Cal.Rptr. 214; *Engineering etc. Corp. v. Longridge Investment Co.*, 153 Cal.App.2d 404, 314 P.2d 563; *Shafford v. Otto Sales Co., Inc.*, 149 Cal.App.2d 428, 308 P.2d 428.

¹¹⁴ *Stark v. Coker*, 20 Cal.2d 839, 129 P.2d 390; *Shafford v. Otto Sales Co., Inc.*, above.

¹¹⁵ *Riddle v. Leuschner*, above; *Stark v. Coker*, above; *Temple v. Bodega Bay Fisheries, Inc.*, 180 Cal.App.2d 279, 4 Cal.Rptr. 300; *Shafford v. Otto Sales Co., Inc.*, above.

¹¹⁶ *Riddle v. Leuschner*, above; *Stark v. Coker*, above; *McCombs v. Rudman*, 197 Cal.App.2d 46, 17 Cal.Rptr. 351; *Talbot v. Fresno-Pacific Corp.*, 181 Cal.App.2d 425, 5 Cal.Rptr. 361; *Claremont Press Publishing Co. v. Barksdale*, Above, 187 Cal.App.2d 813, 10 Cal.Rptr. 214; *Thomson v. L. C. Roney & Co.*, above; *Asamen v. Thompson*, 55 Cal.App.2d 661, 131 P.2d 841; *Sweet v. Watson's Nursery*, 33 Cal.App.2d 699, 92 P.2d 812; *Goldberg v. Engelberg*,

use of the same office or business location; the employment of the same employees and/or attorney;¹¹⁷ the failure to adequately capitalize a corporation; the total absence of corporate assets, and undercapitalization;¹¹⁸ the use of a corporation as a mere shell, instrumentality or conduit for a single venture or the business of an individual or another corporation;¹¹⁹ the concealment and misrepresentation of the identity of the responsible ownership, management and financial interest, or concealment of personal business activities;¹²⁰ the disregard of legal formalities and the failure to maintain arm's length relationships among related entities;¹²¹ the use of the corporate entity to procure labour, services or merchandise for another person or entity;¹²² the diversion by a stockholder or other person or entity, to the detriment of creditors, or the manipulation of assets and liabilities between entities so as to concentrate the assets in one and the liabilities in another;¹²³ the contracting with another with intent to avoid performance by use of a corporate entity as a shield against personal liability, or the use of a corporation as a subterfuge of illegal transactions;¹²⁴ and the formation and use of a corporation to transfer to it the existing liability of another person or entity.¹²⁵ A perusal of these cases reveals that in all instances several of the factors mentioned were present. It is particularly significant that while it was held, in each instance, that the trial court was warranted in disregarding the corporate entity, the factors considered by it were not deemed to be conclusive upon the trier of fact but were found to be supported by substantial evidence.”¹²⁶

The obvious problem of working with a checklist is that a court may shift its focus from the substance of the dispute at hand to a formal checklist, ticking off factors to resolve a

34 Cal.App.2d 10, 92 P.2d 935; *Gordon v. Aztec Brewing Co.*, 33 Cal.2d 514, 203 P.2d 522; *Pan Pacific Sash & Door Co. v. Greendale Park, Inc.*, 166 Cal.App.2d 652, 333 P.2d 802; *Shea v. Leonis*, 14 Cal.2d 666, 96 P.2d 332.

¹¹⁷ *McCombs v. Rudman*, above; *Talbot v. Fresno-Pacific Corp.*, above; *Thomson v. L. C. Roney & Co.*, above; *Pan Pacific Sash & Door Co. v. Greendale Park, Inc.*, above.

¹¹⁸ *Minton v. Cavaney*, 56 Cal.2d 576, 15 Cal.Rptr. 641, 364 P.2d 473; *Automotriz etc. De California S. A. De C. V. v. Resnick*, above; *Stark v. Coker*, above; *Talbot v. Fresno-Pacific Corp.*, above; *Temple v. Bodega Bay Fisheries, Inc.*, above; *Wheeler v. Superior Mortgage Co.*, 196 Cal.App.2d 822, 17 Cal.Rptr. 291; *Claremont Press Publishing Co. v. Barksdale*, 187 Cal.App.2d 813, 10 Cal.Rptr. 214; *Engineering etc. Corp. v. Longridge Investment Co.*, 153 Cal.App.2d 404, 314 P.2d 563; *Shafford v. Otto Sales Co., Inc.*, above; *Shea v. Leonis*, above; *Pan Pacific Sash & Door Co. v. Greendale Park, Inc.*, above.

¹¹⁹ *McCombs v. Rudman*, above; *Asamen v. Thompson*, above; *Engineering etc. Corp. v. Longridge Investment Co.*, above; *Pan Pacific Sash & Door Co. v. Greendale Park, Inc.*, above.

¹²⁰ *Riddle v. Leuschner*, above; *Shafford v. Otto Sales Co., Inc.*, above.

¹²¹ *Riddle v. Leuschner*, above; *McCombs v. Rudman*, above; *Wheeler v. Superior Mortgage Co.*, above; *Pan Pacific Sash & Door Co. v. Greendale Park, Inc.*, above.

¹²² *Temple v. Bodega Bay Fisheries, Inc.*, above; *Pan Pacific Sash & Door Co. v. Greendale Park, Inc.*, above; *Engineering etc. Corp. v. Longridge Investment Co.*, above.

¹²³ *Riddle v. Leuschner*, above; *Thomson v. L. C. Roney & Co.*, above; *Sweet v. Watson's Nursery*, above; *Talbot v. Fresno-Pacific Corp.*, above.

¹²⁴ *Wheeler v. Superior Mortgage Co.*, above; *Claremont Press Publishing Co. v. Barksdale*, above; *Shafford v. Otto Sales Co. Inc.*, above; *Asamen v. Thompson*, above.

¹²⁵ *Shea v. Leonis*, above; *Engineering etc. Corp. v. Longridge Investment Co.*, above.

¹²⁶ 838 and 839.

dispute instead of focusing on the nature of the dispute. A checklist like the one at hand does not offer a weighing of factors: it is not clear which factor would weigh more or be regarded as being the most important. Furthermore the checklist is very diverse which makes reconciliation between the factors as well as weighing the relevance and importance of each factor extremely difficult.¹²⁷

Blumberg also refers to the checklist of Douglas and Shanks.¹²⁸ Douglas and Shanks listed a number of factors which according to them could determine whether a subsidiary company enjoyed a separate existence or not. These factors appear very close or similar to the ones which Muscat argues should provide for liability on a holding company for the debts of an insolvent subsidiary as well as liability to involuntary creditors.¹²⁹ These factors which Douglas and Shanks list are:

- “1. Separate financing and adequacy of capitalisation;
2. Separate day-to-day business operations;
3. Observance of corporate and business formalities;
4. Separate representation of parent and subsidiary to the public.”¹³⁰

6.2.1.4 Single-factor piercing in the United States of America

The classic American piercing of the veil tests employed a three-pronged test,¹³¹ but there has also been a movement towards a single factor test. The single factor test focuses, as the name suggests, on one aspect only to determine whether the holding company should be liable for a debt incurred by a subsidiary. The debt could be of a contractual or a delictual nature. Blumberg lists three overarching single grounds upon which the United States’ courts have been willing to pierce the corporate veil.¹³² Each ground is then also further divided into further sub-categories. The main single factor grounds are, firstly where the subsidiary company patently has no independent existence, secondly where the holding company uses the subsidiary company for fraudulent, inequitable and wrongful

¹²⁷ See also Blumberg *Corporate Groups* 11-33.

¹²⁸ Blumberg *Corporate Groups* 11-34 with reference to Douglas & Shanks “Insulation from Liability through Subsidiary Corporation” (1929) 39 *Yale Law Journal* 193 196-7 218.

¹²⁹ See paras 6.5 and 7.8.

¹³⁰ Blumberg *Corporate Groups* 11-34.

¹³¹ Above.

¹³² Blumberg *Corporate Groups* chapter 12.

purposes and thirdly where the holding company and its subsidiaries or related companies are operated as a single business enterprise.¹³³

6.2.1.4.1 Lack of independent existence

The first ground is the complete lack of any indication that the subsidiary company enjoys any independent existence. Although there appear to be no recent cases after 2000, Blumberg mentions that where the subsidiary company is merely an entity without any substance, lacks assets, staff and a business, the courts have brought such a state of affairs under the single factor piercing doctrine.¹³⁴ This basis for a single-factor test will now be illustrated with reference to a few of the decided cases.

In *Wegerer v First Commodity Corporation of Boston*¹³⁵ First Commodity was a commodity option brokerage firm with its main office in Boston and other offices in Newport Beach, Chicago, Miami, San Francisco and New York. The Wegerers were induced into an agreement to purchase commodity options by an accountant, Jones, of First Commodity in New York and were told to ignore the information booklet which was sent by mail. Soon afterwards they were alerted to the fact that the United States Commodity Futures Trading Commission had banned commodity options. They suffered loss and instituted legal action against First Commodity and its controlling shareholders and directors, the Schleicher brothers. The case against the Schleichers rested on the allegation that they acted outside their official capacities as directors and for their own personal gain. The court held that the Schleichers used First Commodity merely as an instrument for their own personal business affairs and that the corporate veil should be pierced based under the *alter ego* doctrine.

In *Middendorf v Fuqua Industries Inc*¹³⁶ the plaintiff bought property in 1967 subject to a lease agreement with Ward Manufacturing Inc, a company incorporated in Ohio. The lessor / seller of the property was Ward. Interstate Motor Freight System Inc was a

¹³³ Blumberg *Corporate Groups* 12-1 and 12-2.

¹³⁴ Blumberg *Corporate Groups* 12-5.

¹³⁵ *Wegerer v First Commodity Corporation of Boston* 744 F. 2d 719 (Court of Appeal 10th Circuit 1984).

¹³⁶ *Middendorf v Fuqua Industries Inc* 623 F. 2d 13 (Court of Appeals, 6th Circuit 1980).

subsidiary of Fuqua and merged with Ward Ohio. Interstate Motor Freight System then changed its name to Ward Manufacturing Inc, a company of Delaware. Ward of Delaware thus became a subsidiary of Fuqua. Ward of Delaware was eventually dissolved in 1970 and all its assets and liabilities passed to Fuqua, the sole shareholder. All of the assets of Ward of Delaware were then sold to Ward Interfinancial Corporation, a company incorporated in Delaware and whose name in due course was changed to Eldorado Industries Inc. Ward Delaware and Fuqua assigned all of their interests in terms of the lease agreement to Eldorado. Rental was outstanding and the plaintiff instituted action against Fuqua, the holding company of Ward Delaware.

The court stressed that Fuqua controlled every company which was involved with the leased premises after the merger of Ward Ohio into Ward Delaware and before the assignment to Eldorado. Fuqua attempted to escape liability on the basis that it was a mere assignee and not a lessee of the premises in question. Without any evidence of fraud or improper behaviour the court accepted the dictum in *Pepper v Dixie Splint Coal Co*¹³⁷ where the Virginian court stated that:

“The actual and ultimate control and ownership of the property and business of the three companies was lodged in Litton and Long. Such complete dominance and control by them made the two corporations and the copartnership, quoad the appellant, merely a veil or shadow through which the court will look to the substance of things whenever it would be unconscionable, through corporate fiction or otherwise, to permit the responsible parties to escape liability by turning over their property from one entity to another. The form changed, but the real parties in interest always remained the same.”¹³⁸

In *West Building Materials Inc v Daley*¹³⁹ the court adopted a stricter approach to veil piercing using the single-factor doctrine. West Building Materials was a creditor of All South Builders Inc, a company in which Daley and his family owned all the shares. West Building Materials supplied All South Builders Inc with materials and was not paid. The plaintiff alleged that Daley was personally liable since he acted fraudulently by using the building materials for his own benefit and, in the absence of fraud, the assets of Daley

¹³⁷ *Pepper v Dixie Splint Coal Co* 165 Va(Virginia) 179, 181 S.E 406 (1935).

¹³⁸ 17 with reference to the *Dixie Splint Coal* case 410.

¹³⁹ *West Building Materials Inc v Daley* 476 So.2d 554 (Court of Appeal of Louisiana, 3rd Circuit)(1985).

and those of All South were so interwoven that a person could not distinguish between them. Furthermore there was an allegation that some corporate formalities were not followed. The court found that there was no fraud. Furthermore, regarding piercing of the veil in the absence of any fraud it concluded as follows:

“As previously stated, in the absence of fraud or deceit, the totality of circumstances must clearly indicate that the shareholder and the corporation were acting as one. The use of some of the building materials for Daley’s personal benefit was properly considered by the trial court as only one of the factors to be weighed.

The trial court applied the proper test for consideration of the totality of the circumstances. The court said that the proper factors to consider are, ‘co-mingling[sic] of corporate and shareholder funds; failure to follow statutory formality for incorporation and the transaction of corporate affairs; failure to provide separate bank accounts and records; and failure to hold regular shareholders or directors meetings.’ Applying the evidence to these considerations the court held ‘it is evident that there was neither co-mingling [sic] of corporate funds with those of any shareholders, nor was there a failure to provide separate accounts and records for the corporation. It appears that All South Builders, Inc. was properly incorporated, and although there were no regular shareholders’ meetings, this is not enough to allow piercing of the corporate veil.’ We agree.”¹⁴⁰

In *Edwards Company Inc v Monogram Industries Inc*¹⁴¹ Edwards Inc wanted to hold Monogram Inc, the holding company of Monotronics Inc, liable for a contractual debt. The court affirmed that to pierce the veil, fraud or an injustice must be shown and that it was not sufficient merely to show that the subsidiary acted as the representative of the holding company.¹⁴² The plaintiffs also alleged that the subsidiary was merely a piece of paper. The court held that the mere fact that (excessive) control exists is insufficient to pierce the corporate veil.¹⁴³

¹⁴⁰ 558-559.

¹⁴¹ *Edwards Company Inc v Monogram Industries Inc* 730 F. 2d 977 (United States Court of Appeals, 5th Circuit).

¹⁴² The court stated at 983 -984: “Thus, we believe that the panel erred in concluding that, in a contract case, a plaintiff need only show that a subsidiary is a mere agent or conduit of the parent to pierce the corporate veil. A showing that the subsidiary was used by the parent for fraud or injustice must also be present.”

¹⁴³ The court held at 986 – 987: “Undoubtedly, Monotronics was ultimately controlled by Monogram. This will always be the case where a parent corporation has a wholly-owned subsidiary. It does not necessarily follow, however, that the subsidiary has no separate existence.”

Blumberg also states that the courts may pierce the corporate veil under the first ground for single-factor piercing where certain corporate formalities are not respected, namely the holding of separate board and shareholder meetings, the keeping of proper minutes of the subsidiary and maintaining a generally separate existence of the subsidiary.¹⁴⁴ In *Browning-Ferris Industries of Illinois Inc v Ter Maat*¹⁴⁵ the defendant was the major shareholder of MIG Investments Inc and AAA Disposal Systems Inc. Browning-Ferris and its predecessor operated a landfill site and subsequently AAA and MIG operated it as well. The site was toxic due to the pollution by Browning-Ferris and others who then agreed to clean it up in terms of the Comprehensive Environmental Response Compensation and Liability Act (CERCLA). In terms of CERCLA it was possible for a person who cleaned up a toxic waste site to seek a contribution from another person who was also responsible for the pollution.¹⁴⁶ The plaintiffs alleged that Ter Maat was liable for the actions of AAA and MIG, which had no assets, and alternatively that AAA was liable for the actions of MIG since they were related parties. The court especially distinguished voluntary creditors and involuntary creditors. The position of voluntary creditors was easier to deal with for the court especially where the holding company allowed the subsidiary to appear more solvent than it in fact was. The position of involuntary creditors was however more difficult.

“Analysis is more difficult in the case of an involuntary creditor, such as the plaintiffs here, who wish to be compensated for having in effect ‘lent’ the money to clean up the site of the former landfill but lent under compulsion, having been forced to clean it up by the Superfund law rather than pursuant to a contract with the ‘debtors,’ such as M.I.G. In such a case there is no issue of protecting reliance induced by misrepresentations by the debtor. The plaintiffs in dumping toxic wastes to the landfill obviously were not relying on M.I.G.’s appearing to have greater assets than it actually had. In these circumstances we can think of only two arguments for piercing the corporate veil. The first is that the owners may have so far neglected the legal requirements (requirements not intended solely for the protection of creditors) for operating in the corporate form that they should be taken to have forfeited its protections, forfeiture thus operating to enforce the legal requirements that the state has seen fit to impose on investors who want the benefits of limited liability. Moreover, if the formalities have been flouted, it becomes hard to see how the investors could reasonably have relied on the protections of limited liability; they would have

¹⁴⁴ Blumberg *Corporate Groups* 12-8.

¹⁴⁵ *Browning-Ferris Industries of Illinois Inc v Ter Maat* 195 F. 3d 953 (Court of Appeals, 7th Circuit).

¹⁴⁶ S 113(f)(1) of CERCLA.

known they were skating on thin ice. In such a case the investment-encouraging function of limited liability is attenuated.

Second, it could be argued that enterprises engaged in potentially hazardous activities should be prevented from externalizing the costs of those activities, by being required to maintain or at least endeavor to maintain a sufficient capital cushion to be answerable in a tort suit should its activities cause harm and give rise to liability, on pain of its shareholders' and affiliates' losing their limited liability should the corporation fail to do this. This argument has not carried the day in any jurisdiction that we are aware of, presumably because of the risks that it would impose on shareholders and because the potential victims of the corporation's hazardous activities can be protected without making inroads into limited liability by requiring enterprises engaged in such activities to post a bond large enough to assure that any judgment against the corporation will be collectible. Courts do, it is true, frequently mention 'undercapitalization' as a separate ground from neglect of corporate formalities for piercing the corporate veil. They do not do so on the basis of unusual risks to potential tort victims or other involuntary creditors, however, though conceivably such concerns are in the background of their thinking."¹⁴⁷

From the above it would appear that in respect of the first ground the court adopts the same language as the Court of Appeal in the *Adams v Cape Industries Plc* case, namely that limitations in law should be adhered to. The second ground appears to be a mixture of the arguments of Hansmann and Kraakman,¹⁴⁸ Fischel and Easterbrook¹⁴⁹ and the undercapitalisation of a company.

The third manner under the first single-factor piercing doctrine is where the subsidiary does not independently make decisions or where the holding company exercises excessive control over the affairs of the subsidiary company.¹⁵⁰

¹⁴⁷ 959 – 961, internal references omitted.

¹⁴⁸ See 6.4 below.

¹⁴⁹ See 6.4 below.

¹⁵⁰ See *United States v Reading Co* 253 U.S 26, 40 S. Ct. 425, 64 L.Ed. 760, 3 A.F.T.R 3067 (above) and *United States v Lehigh* 220 U.S 257, 31 S.Ct. 387, 55 L.Ed 458, 3 A.F.T.R 2855 (above).

6.2.1.4.2 Piercing of the corporate the veil in cases of fraud, inequitable conduct or wrongful purpose

The second ground under which the United States' courts have applied a single-factor piercing test is where the holding company uses the subsidiary as an instrument to perpetrate a fraud or for inequitable or wrongful purposes.¹⁵¹

In *Farr v Sun World Savings Association*¹⁵² the Texas Court of Appeals held that the mere fact that a shareholder kept the businesses and affairs of the controlled company separate from the business and affairs of the shareholders would not be sufficient to escape liability under veil piercing where fraud has been perpetrated. The Texas Court of Appeals held in the context of the Texas Business Corporations Act,¹⁵³ the aim of which was to restrict the court's power to pierce the corporate veil, that:

“Carefully preserved, however, is the right of a person to go behind the corporate entity in order to establish individual shareholder liability by a showing of actual or common law fraud. Where actual fraud primarily for the benefit of the perpetrating shareholder or shareholders can be shown, the various doctrines for disregarding the corporate entity, including alter ego and a sham to perpetrate a fraud, are still very much alive.”¹⁵⁴

The Texas Business Corporations Act has been drafted broadly to limit the powers of a court to pierce the corporate veil. The Act essentially provided that the corporate veil may only be pierced in cases of actual fraud where the perpetrator of the fraud aimed to receive a direct personal benefit.

The ratio behind the Texas Business Corporations Act was the decision of *Castleberry v Branscum*¹⁵⁵ where the Supreme Court of Texas held that:

“Neither fraud nor an intent to defraud need be shown as a prerequisite to disregarding the corporate entity; it is sufficient if recognizing the separate corporate existence would bring about an inequitable result. Thus, we held that note holders could disregard the corporate fiction without showing common-law fraud or deceit when the circumstances amounted to constructive fraud.

¹⁵¹ Blumberg *Corporate Groups* 12-13.

¹⁵² *Farr v Sun World Savings Association* 810 S.W 2d 294 (Texas Court of Appeals 1991).

¹⁵³ Art 2.21.

¹⁵⁴ 296.

¹⁵⁵ *Castleberry v Branscum* 721 S.W 2d 270 (Texas Supreme Court 1986).

Whether [the individual] misled them or subjectively intended to defraud them is immaterial [...] [f]or the action was so grossly unfair as to amount to constructive fraud. To prove there has been a sham to perpetrate a fraud, tort claimants and contract creditors must show only constructive fraud. Actual fraud usually involves dishonesty of purpose or intent to deceive, whereas constructive fraud is the breach of some legal or equitable duty which, irrespective of moral guilt, the law declares fraudulent because of its tendency to deceive others, to violate confidence, or to injure public interests.”¹⁵⁶

Since constructive fraud was sufficient for the piercing of the corporate veil, the Texas legislature introduced the Texas Business Corporation Act to limit the piercing circumstances and as a consequence the Texas court, in its dictum in *Farr v Sun World Savings Association*¹⁵⁷ restricted itself to actual fraud that had to be proved if a plaintiff wanted to rely on fraud as a basis for piercing the corporate veil. It would appear that the alter ego doctrine requires a more continuous or ongoing eradication of the separate entity principle, namely that the shareholders and the company are continuously interchanged so that there is no real separation between the two bodies. Fraud on the other hand may relate to a single act, which has to be shown to have brought about an inequitable result. An inequitable result should however be viewed restrictively and be seen in the context of what is called “constructive fraud,” namely where an act has been deceiving, violated confidence or injured public interests as enunciated in the *Castleberry* case.

In *My Bread Baking Company v Cumberland Farms Inc*¹⁵⁸ the court stated that in Massachusetts the corporate veil will be pierced where:

“Although common ownership of the stock of two or more corporations together with common management, standing alone, will not give rise to liability on the part of one corporation for the acts of another corporation or its employees, additional facts may be such as to permit the conclusion that an agency or similar relationship exists between the entities. Particularly is this true (a) where there is active and direct participation by the representatives of the one corporation, apparently exercising some form of pervasive control, in the activities of another and there is some fraudulent or injurious consequence of the intercorporate relationship, or (b) when there is a confused intermingling of activity of two or more corporations engaged in a common enterprise

¹⁵⁶ 272-273, internal references omitted.

¹⁵⁷ Above.

¹⁵⁸ *My Bread Baking Company v Cumberland Farms Inc* 353 Massachusetts 614, 233 N.E 2d 748 (1968).

with substantial disregard of the separate nature of the corporate entities, or serious ambiguity about the manner and capacity in which the various corporations and their respective representatives are acting. In such circumstances, in imposing liability on one or more of a group of ‘closely identified’ corporations, a court ‘need not consider with nicety which of them’ ought to be held liable for the act of one corporation.”¹⁵⁹

In *Pepsi-Cola Metropolitan Bottling Company Inc v Checkers Inc*¹⁶⁰ the court confirmed the ratio in *My Bread Baking* but further held that:

“While we have been directed to no Massachusetts case treating the question of disregard of the separate existence of a close corporation in greater depth, courts in other jurisdictions usually weigh a list of factors, including insufficient capitalization for purposes of the corporate undertaking, nonobservance of corporate formalities, nonpayment of dividends, insolvency of the corporation at the time of the litigated transaction, siphoning of corporate funds by the dominant shareholders, nonfunctioning of officers and directors other than the shareholders, absence of corporate records, use of the corporation for transactions of the dominant shareholders, and use of the corporation in promoting fraud. [...] Where the principal shareholders of a close corporation fail to observe with care the corporation’s existence, a court will not later heed their request to do so.”¹⁶¹

In *Evans v Multicon Construction Corporation*¹⁶² the Court of Appeals considered the *My Bread* and *Pepsi* cases and held that:

“Four indicators point in favor of piercing the corporate veil, eight are against, but the exercise is, of course, not one in counting. One examines the twelve factors [as listed in the *Pepsi* case] to form an opinion whether the over-all structure and operation misleads. There is present in the cases which have looked through the corporate form an element of dubious manipulation and contrivance, finagling, such that corporate identities are confused and third parties cannot be quite certain with what they are dealing.”¹⁶³

¹⁵⁹ 619, 752.

¹⁶⁰ *Pepsi-Cola Metropolitan Bottling Company Inc v Checkers Inc* 754 F. 2d 10 (Massachusetts Court of Appeals 1985).

¹⁶¹ 16.

¹⁶² *Evans v Multicon Construction Corporation* 30 Massachusetts Court of Appeals 728, 574 N.E 2d 395 (Massachusetts Court of Appeals 1991).

¹⁶³ 400.

The most recent case which could be found in Massachusetts was *George Hyman Construction Company v Gateman*.¹⁶⁴ The court held, with reference to the *My Bread, Pepsi* and *Evans* decisions, especially in respect of the weighing of the factors to determine whether piercing should be allowed or not, that:

“The factors are weighed, not counted. Counting alone is insufficient to pierce because instead “[o]ne examines the twelve factors to form an opinion whether the over-all structure and operation misleads. There is present in the cases which have looked through the corporate form an element of dubious manipulation and contrivance, finagling, such that corporate identities are confused and third parties cannot be quite certain with what they are dealing.”¹⁶⁵

In Massachusetts therefore the courts use a balancing test by looking at various factors rather than a single-factor piercing test. This balancing test could be compared to the *Cape Pacific v Lubner Controlling Investments*¹⁶⁶ case where the court looked at the policy of separate juristic personality which had to be weighed up against the factors justifying piercing the corporate veil after some form of fraud, improper conduct or dishonesty has been established.

Another ground which the courts have considered under the second single-factor piercing doctrine is the excessive fragmentation of an enterprise. In *Papa v Katy Industries Inc*¹⁶⁷ the court had to consider a matter dealing with the anti-discriminatory laws of the United States which among other grounds prevents discrimination based on age or disability in the workplace, i.e. excessive fragmentation within the context of the possible evasion of legislation. Papa was employed by Walsh Press Company, the wholly-owned subsidiary of Katy Industries Inc. The relevant statute only applied to employers which employed more than a certain minimum number of employees. Walsh Press employed less than the statutory minimum number of employees and was therefore not covered by the anti-discrimination statutes. Katy, however, had a number of subsidiary companies which in combination employed more than one thousand employees. Walsh received a directive from Katy that some of its employees had to be retrenched and Papa was one of those

¹⁶⁴ *George Hyman Construction Company v Gateman* 16 F. Supp 2d 129 (D. Mass. 1998).

¹⁶⁵ 158.

¹⁶⁶ See para 2.7.2 above.

¹⁶⁷ *Papa v Katy Industries Inc* 166 F. 3d 937 (Illinois Court of Appeals, 7th Circuit) (1999). The court dispensed with a similar aspect in the same matter, *Equal Employment Opportunity Commission v GJHSRT Inc.*

retrenched. Furthermore, to illustrate the extent of the integration between Katy and Walsh, Katy fixed the salaries of the employees of Walsh, the computer systems were integrated and cheques above a certain limit needed approval by Katy.

The Illinois Court of Appeals first considered the rationale behind the exclusion of smaller employers from the anti-discrimination statutes. The court then looked at the circumstances when it would pierce the corporate veil. It listed three grounds upon which it would pierce the corporate veil. In respect of the situation where there is clearly one enterprise which has divided itself up into numerous parts the court stated that:

“Second, an enterprise might split itself up into a number of corporations, each with fewer than the statutory minimum number of employees, for the express purpose of avoiding liability under the discrimination laws. The division might be accomplished in such a way as to avoid creating the conditions in which the corporate veil is normally pierced. Each subsidiary might be adequately funded and comply with all requisite formalities for separate corporate status, and the group might make clear to all employees and all creditors that they could look only to the particular corporation with which they had dealt for the enforcement of their contractual entitlements. But if the purpose of this splintered incorporation were to elude liability under the antidiscrimination laws, the corporations should be aggregated to determine how many employees each corporation had. The privilege of separate incorporation is not intended to allow enterprises to duck their statutory duties.”¹⁶⁸

On the facts the court then held that:

“There is no suggestion in either one that the business enterprise was splintered into separate corporations in order to defeat the antidiscrimination laws; Walsh, for example, was acquired, not created, by Katy. There is no showing that an ordinary creditor of one of the subsidiaries could pierce the corporate veil and sue the parent corporation or any of the other subsidiaries. There is no suggestion that the parent, or any other affiliate of Walsh's, or the enterprise as a whole formulated or administered the specific personnel policies, or directed, commanded, or undertook the specific personnel actions, of which the plaintiffs are complaining. It is true that Katy in a sense ‘caused’ the firing of Papa by ordering Walsh to curtail its operations; for, had Walsh not curtailed them, Papa would probably not have been laid off, or not so soon. But Papa cannot complain of being laid off as such; the antidiscrimination laws do not forbid layoffs. He can complain only if he was selected for layoff on some forbidden ground. Maybe he was, but there is

¹⁶⁸ 941.

no suggestion that Katy (or any of Katy's other subsidiaries) was responsible for his being selected for layoff, let alone for Walsh's having picked on him for a forbidden reason."¹⁶⁹

Blumberg states that a number of cases have applied the excessive fragmentation principle as one of the factors which needs to be taken into account when the court is approached to pierce the corporate veil. Other factors which some courts would consider next to excessive fragmentation would invariably be the non-compliance with corporate formalities, total domination and undercapitalisation.¹⁷⁰ Blumberg states that there would not appear to be any case law in respect of piercing the corporate veil where a court has held that excessive fragmentation was the sole reason for piercing the veil. The excessive fragmentation principle was always a (important) factor that was taken into account. This would especially be the case where an enterprise fragments itself for the sole purpose to escape (pre)existing liabilities or future liability claims.¹⁷¹

Naturally it is extremely difficult to determine when a company has fragmented itself excessively. One only needs to look at multinational companies and the number of subsidiaries which exist all over the world. Often the operations of all the subsidiaries would be the same as the holding company and each other and with similar logistical and operational structures. In cases where the (sole) purpose of the fragmentation is to escape liability under statute or otherwise, it is easy to pierce the veil and one wonders whether the court needs to discuss excessive fragmentation where it could have used fraud or the inequitable result which flowed from the fragmentation. The question therefore remains whether the veil should be pierced where there is clearly a single economic or business enterprise in the absence of any bad faith. It would further be interesting within the current South African milieu as to what a court would find where an employer fragments its operations to avoid the affirmative-action provisions of the Employment Equity Act,¹⁷² in terms of which employers with less than fifty employees or less than a specified income do not have to comply with the affirmative-action provisions. It is also interesting

¹⁶⁹ 942.

¹⁷⁰ Blumberg *Corporate Groups* 12-23.

¹⁷¹ Blumberg *Corporate Groups* 12-24 and 12-25, but see also the *Adams v Cape plc* case above.

¹⁷² 55 of 1998.

to compare such a decision with the *Dadoo*¹⁷³ case. One could argue that *Dadoo* was decided soon after *Salomon* and that it provided justification not to pierce the veil although a more political interpretation would be that the court was not willing to give credence to unjust legislation. The case was however in contrast to the *Daimler Co Ltd v Continental Tyre and Rubber Co (Great Britain) Ltd*¹⁷⁴ where the court held that a company was an enemy company because it had German shareholders, bar one, despite it being incorporated in England. This decision was however during the First World War where Germany was the enemy and the more cynical interpretation would be that this played a role. By analogy the Employment Equity Act is there to promote equality and a device to avoid the provisions of the Act would probably be interpreted like the *Continental Tyre* case and not like the *Dadoo* case.¹⁷⁵

6.2.1.4.3 Single economic unit

The third ground for veil piercing falling outside the traditional grounds was developed in Texan and Louisianan law. The leading case in Texas used to be the case of *Paramount Petroleum Corporation v Taylor Rental Center*.¹⁷⁶ The facts in this case, as in most (if not all) veil piercing cases are crucial to understand why the court decided to pierce the veil. Taylor rented out certain equipment, which was used on ships, to a Captain Jackson and a Captain Weld respectively. Jackson gave a telephone number where credit information could be obtained. The number was that of Paramount Petroleum. Taylor was told to send invoices to the Houston post office box of Paramount. Captain Weld, when he leased the equipment presented a business card bearing the name Paramount Steamship Company Ltd. The invoices in respect of the rentals were never paid. The court held as follows:

“The first theory justifying the trial court's judgment is the ‘single business enterprise’ theory. When corporations are not operated as separate entities but rather integrate their resources to

¹⁷³ See para 2.7.2 above.

¹⁷⁴ *Daimler Co Ltd v Continental Tyre and Rubber Co (Great Britain) Ltd* [1916] 2 AC 307, [1916-17] All ER Rep 191 (HL).

¹⁷⁵ Larkin “Regarding judicial disregarding of the company’s separate identity” (1989) 3 *SA Merc LJ* 277 289-296 where the author argues that the *Dadoo* case and the *Continental Tyre* cases are indistinguishable and that the former may have been decided on a deeper constitutional basis in the light of the racial nature of the case. See 296 where Larkin argues that the court may have sought “refuge in extreme [legal] technicality” to arrive at its decision.

¹⁷⁶ *Paramount Petroleum Corporation v Taylor Rental Center* 712 S.W 2d 534 (Texas Court of Appeals, 14th District).

achieve a common business purpose, each constituent corporation may be held liable for debts incurred in pursuit of that business purpose. Factors to be considered in determining whether the constituent corporations have not been maintained as separate entities include but are not limited to the following: common employees; common offices; centralized accounting; payment of wages by one corporation to another corporation's employees; common business name; services rendered by the employees of one corporation on behalf of another corporation; undocumented transfers of funds between corporations; and unclear allocation of profits and losses between corporations.

We find the present record contains evidence sufficient to justify an implied finding that Petroleum and Steamship operated as a single business enterprise. The same shareholder owned all of the stock in both companies. The two companies operated from the same Houston office. They used the same telephone number and the same post office box. Both companies paid funds to Captain Jackson for repair work on the Courtney D. The employees of both companies referred to both companies as 'Petroleum'. Petroleum transferred funds, with no ledger entries, to a checking account over which an employee of Steamship was signatory. The president of Steamship testified that assets of Petroleum were seized when the Courtney D was seized. All accounting for the two companies was performed at the Houston office by an employee paid by Petroleum. Finally, Petroleum failed to produce, in response to discovery requests, any corporate records of either corporation. This evidence demonstrates that the corporations were not operated as separate entities. Therefore, we find the single business enterprise theory supported by the evidence.”¹⁷⁷

The most recent Texan case in which the Texas Supreme Court had an opportunity to (re)consider the *Paramount Petroleum* case was *SSP Partners and Metro Novelties Inc v Gladstrong Investments (USA) Corporation*.¹⁷⁸ A boy was killed in a fire at home which was caused by a WAX-brand disposable lighter, which had a defective child-resistant mechanism. The lighters were manufactured in China by Tianjin Sico Lighters Company Limited and exported by Gladstrong Hong Kong, both Chinese companies. Gladstrong Hong Kong designed and patented the safety wheel of the lighters in question and gave instructions to Tianjin Sico regarding how to manufacture the lighters.

Gladstrong Hong Kong was the holding company of Gladstrong USA, which imported, marketed and distributed the lighters in the United States of America. Gladstrong Hong

¹⁷⁷ 536-537, internal references omitted.

¹⁷⁸ *SSP Partners and Metro Novelties Inc v Gladstrong Investments (USA) Corporation* 275 S.W 3d 444 (Texas Supreme Court, 14 November 2008).

Kong perceived and advertised Gladstrong USA as its branch office. All the employees, bar one, were of the same family.

Metro Novelties was incorporated in Texas and sold the WAX lighters to SSP which in turn sold them through retailers. The aunt of the deceased boy bought two of the lighters and one of them caused the house fire. The parents instituted legal action against SSP and Gladstrong USA. SSP sought indemnity from Metro and both of them sought indemnity from Gladstrong USA. The parents settled their claim against Gladstrong USA and SSP and SSP settled its indemnity claim against Metro. SSP and Metro then sought their indemnity from Gladstrong USA in terms of the Federal Consumer Product Safety Act read with the Texas Civil Practice and Remedies Code. The Texas Code¹⁷⁹ provided that a statutory indemnity is owed by a manufacturer. SSP and Metro alleged that Gladstrong USA was the manufacturer of the WAX lighters, alternatively that Gladstrong USA was part of a single business enterprise, namely Gladstrong Hong Kong, which was the manufacturer of the WAX lighters.

SSP and Metro Novelties relied on the dictum in the *Paramount Petroleum Corporation v Taylor Rental Center*¹⁸⁰ case. SSP and Metro alleged that the evidence showed that all the factors as listed in the *Paramount Petroleum* case were satisfied. The court then concluded as follows:

“Creation of affiliated corporations to limit liability while pursuing common goals lies firmly within the law and is commonplace. We have never held corporations liable for each other's obligations merely because of centralized control, mutual purposes, and shared finances. There must also be evidence of abuse, or as we said in *Castleberry*, injustice and inequity. By ‘injustice’ and ‘inequity’ we do not mean a subjective perception of unfairness by an individual judge or juror; rather, these words are used in *Castleberry* as shorthand references for the kinds of abuse, specifically identified, that the corporate structure should not shield - fraud, evasion of existing obligations, circumvention of statutes, monopolization, criminal conduct, and the like. Such abuse is necessary before disregarding the existence of a corporation as a separate entity. Any other rule would seriously compromise what we have called a ‘bedrock principle of corporate law’ - that a legitimate purpose for forming a corporation is to limit individual liability for the corporation's

¹⁷⁹ Chapter 82.

¹⁸⁰ Above

obligations. In *Castleberry*, we held that the corporate structure could be disregarded on a showing of constructive fraud, even without actual fraud. The Legislature has since rejected that view in certain cases. *The single business enterprise liability theory is fundamentally inconsistent with the approach taken by the Legislature.* Accordingly, we hold that the single business enterprise liability theory set out in *Paramount Petroleum* will not support the imposition of one corporation's obligations on another. Although Gladstrong USA was entitled to summary judgment on this issue, for reasons explained below, we conclude that the case must be remanded to the trial court for further proceedings. SSP will be free to assert a valid theory for requiring Gladstrong USA to meet any indemnity obligation Gladstrong Hong Kong may have.”¹⁸¹

It would therefore appear that the Texas Supreme Court has rejected the single enterprise liability theory and that the only basis upon which it would pierce the corporate veil would be under the grounds listed in the *Castleberry* case, read with the Texas Business Corporations Act. It appears however that the single business enterprise argument was rejected due to the provisions of the Texas Business Corporations Act and not as a matter of principle.

Louisiana applies the single business enterprise theory and only the leading case will be referred to, namely *Green v Champion Insurance Company*,¹⁸² which is still valid law. The case arose in the context of insurance law. Boardwalk was the holding company of UFS,¹⁸³ as well as the holding company of CCC, an insurance holding company. Champion was the wholly-owned subsidiary of CCC as were USU, SEUS and UST. The Eicher family basically controlled all the companies in the group. USU, SEUS and UST were the general agents of Champion and carried on its business. Champion had no employees of its own and employees were used interchangeably by Champion and its fellow subsidiaries.

Champion became insolvent and its liquidator applied, *inter alia*, for a declaratory order that Champion and the companies within the Boardwalk group formed a single business enterprise.

¹⁸¹ 454-456, internal references omitted, my italics.

¹⁸² *Green v Champion Insurance Company* 577 So. 2d 249 (Louisiana Court of Appeal, 1st Circuit 1991).

¹⁸³ The company was a premium finance company and limited function financial institution, a concept which is not explained in the case.

The court held that:

“The legal fiction of a distinct corporate entity may be disregarded when a corporation is so organized and controlled as to make it merely an instrumentality or adjunct of another corporation. If one corporation is wholly under the control of another, the fact that it is a separate entity does not relieve the latter from liability. In such instance, the former corporation is merely an alter ego or a business conduit of the latter. When corporations represent precisely the same single interest, the court is free to disregard their separate corporate identity. It is clear that courts can pierce the veil of a corporation in order to reach the “alter egos” of the corporate defendant. This is especially true where the corporations constitute a single business. Courts have been unwilling to allow affiliated corporations that are not directly involved to escape liability simply because of the business fragmentation. Where a single corporation has been fragmented into branches that are separately incorporated and are managed by a dominant or parent entity, or have interlocking directorates, the courts have held the dominant or parent corporation liable for the obligations of its branches whenever justice requires protection of the rights of third persons.

In addition to using a ‘piercing the veil’ theory to disregard a corporate identity, some courts have utilized the ‘single business enterprise’ or ‘instrumentality’ theory to extend liability beyond a separate entity. Prior Louisiana jurisprudence deals primarily with piercing of the corporate veil to hold a parent corporation solidary liable for the debts of its subsidiary. The trial court in this case utilized the ‘single business enterprise’ theory to disregard the identities of a group of separate corporations. Such a situation has not been specifically addressed by our courts. When determining whether a corporation is an alter ego, agent, tool or instrumentality of another corporation, the court is required to look to the substance of the corporate structure rather than its form.”¹⁸⁴

The court then listed a number of factors which had been used in previous cases to successfully argue that a group of companies was a single economic unit.¹⁸⁵ The court,

¹⁸⁴ 257.

¹⁸⁵ Corporations with identity or substantial identity of ownership, namely ownership of sufficient stock to give actual working control; common directors or officers; unified administrative control of corporations whose business functions are similar or supplementary; corporation financing another corporation; inadequate capitalization (“thin incorporation”); corporation causing the incorporation of another affiliated corporation; corporation paying the salaries and other expenses or losses of another corporation; receiving no business other than that given to it by its affiliated corporations; corporation using the property of another corporation as its own; non-compliance with corporate formalities; common employees; services rendered by the employees of one corporation on behalf of another corporation; common offices; centralized accounting; undocumented transfers of funds between corporations; unclear allocation of profits and losses between corporations; and excessive fragmentation of a single enterprise into separate corporations (257-258).

however, stressed that these factors did not form an exhaustive list but was merely illustrative of the circumstances under which the court may be willing to treat a group of companies as single economic unit.¹⁸⁶

On the facts the court found that the Boardwalk group of companies constituted a single business enterprise.¹⁸⁷ The effect of such a finding was that a court could impose liability on each of the group members to “prevent fraud or achieve equity.”¹⁸⁸

According to Blumberg it is not clear how this decision relates to the classic piercing of the corporate veil doctrine. The reasoning of the court is also not clear at times. It would appear that the single business enterprise could be seen as a broad interpretation of the alter ego doctrine from the reasoning in the judgment.¹⁸⁹ If the business is indeed a single entity then certainly an argument can be made that the different components are merely alter egos of each other and especially of the dominant holding company.

A further issue which has not been directly addressed by the Louisiana courts is whether some form of fault or wrongful conduct is needed before the single business enterprise doctrine will be applied.¹⁹⁰ The context of the *Green v Champion* case could also be relevant since it concerned insurance law: if the various companies within the Boardwalk stable were not one single enterprise, a large segment of the public could have been prejudiced. The question is whether the same would apply in the private sphere, namely where there were only a few people harmed. According to Blumberg there have been cases in Louisiana where the single business enterprise doctrine has been accepted by the

¹⁸⁶ 258.

¹⁸⁷ 258-259.

¹⁸⁸ 259.

¹⁸⁹ “It is clear that courts can pierce the veil of a corporation in order to reach the “alter egos” of the corporate defendant. This is especially true where the corporations constitute a single business.”

¹⁹⁰ Blumberg *Corporate Groups* 12-44 and 12-45 with reference to *Pine Tree Associates v Doctors Associates Inc* 654 So. 2d 735 (Louisiana Court of Appeals 1995), *In re New Orleans-Train Car Leakage Fire Litigation* 690 So. 2d 255 (Louisiana Court of Appeals 1997) and *Thibodeaux v Ferrellgas Inc* 741 So. 2d 34 (Louisiana Court of Appeals 1999).

courts in more private legal disputes, i.e. where there were only a restricted number of people harmed.¹⁹¹

In *Pine Tree Associates v Doctors' Associates* a lease agreement was entered into by Pine Tree (the lessors) and Subway Restaurants Inc (the lessees). The Louisiana Court of Appeals confirmed the *Green v Champion Insurance* test and the single business enterprise doctrine. *In casu* Pine Tree alleged that Subway and a number of other entities were the *alter egos* of Doctors' Associates and that Doctors' Associates were liable for the outstanding rent. Doctors' Associates alleged that there was no fraud present and that in the absence of fraudulent activity, the corporate veil could not be pierced in a contractual dispute. The Court of Appeal held, with reference to the *Green* case and *Riggins v Dixie Shoring Co Inc*,¹⁹² that fraud was not a prerequisite for a court to apply the "totality of the circumstances" test to determine whether the circumstances justified the piercing of the corporate veil.¹⁹³ The court further stated that the alter ego doctrine is applied "pursuant to either the single enterprise theory or the piercing [of] the veil theory." This would indicate that the single business enterprise doctrine is not the same as the piercing of the corporate veil theory and that the two are alternatives.

In *In Re New Orleans Train Car Leakage Fire Litigation*¹⁹⁴ there was a class action based on a railway tank car which caught fire and which caused damage to a number of persons. Alabama Great Southern Railroad Company and New Orleans Terminal Company were subsidiary companies of Norfolk Southern Corporation and Norfolk Southern Railway Company. The plaintiffs alleged that the two subsidiary companies were negligent and that this negligence resulted in the tank car fire and the consequent damage. The plaintiffs, after instituting the legal action against the two subsidiary companies, added the two holding companies to the legal action on the basis that the four companies constituted one business enterprise. The holding companies excepted against

¹⁹¹ Blumberg *Corporate Groups* 12-44. See *Lifemark Hospitals Inc v St Jude's Hospital of Kenner Louisiana Inc* 720 So. 2d 1244 (Louisiana Court of Appeals 1998) and *Pine Tree Associates v Doctors Associates Inc* 654 So. 2d 735 (Louisiana Court of Appeals 1995).

¹⁹² *Riggins v Dixie Shoring Co Inc* 590 So. 2d 1164, 1167 (Louisiana 1991).

¹⁹³ 7.

¹⁹⁴ *In Re New Orleans Train Car Leakage Fire Litigation* 690 So.2d 255 (Louisiana Court of Appeals, 4th Circuit, 5 March 1997).

being joined as defendants, arguing that they were not involved with the alleged negligent acts of their subsidiary companies. The court *a quo* rejected their exception and they appealed the decision.

The Louisiana Court of Appeals in its judgment recognised the single business enterprise theory and referred approvingly to the *dicta* in the *Green v Champion Insurance*¹⁹⁵ and *Riggins v Dixie Shoring Co Inc.*¹⁹⁶ The court, however, did not delve into the merits of the case before it. Instead it focused on a procedural aspect, namely that once the defendants showed in the court *a quo* in their motion for exception that they were separate legal entities from their subsidiaries, the onus shifted to the plaintiffs to show that the various entities constituted a single business enterprise. There was no allegation by the plaintiffs that the holding companies were negligent, but their cause of action was based on the sole ground that the four entities constituted a single business enterprise. The Court of Appeal does not address this issue which would suggest, considering that the *Riggins*, *Green* and *Pine Tree* cases all rejected fraud as a requirement for the single business enterprise theory, that negligence was also not a requirement in a delictual claim based on the single business enterprise theory. The assumption would therefore be that where “one leg” of the single enterprise acted negligently, the whole business enterprise acted negligently. This could either imply some form of agency or vicarious liability or simply that any “entity” within the single business enterprise could at any stage act as principal in a contract or as wrongdoer in a delictual claim, thereby imposing liability on the other components of the enterprise.

6.3 Evaluation of the piercing of the corporate veil as remedy

It has been shown above that there is no substantive distinction between the instrumentality test and the alter ego test.¹⁹⁷ Both have virtually the same elements and their application seems very similar. The so-called single-factor piercing jurisprudence also does not seem to be specifically based only on one single factor. A number of factors are seemingly taken into account to arrive at an answer which is then put under one

¹⁹⁵ Above.

¹⁹⁶ Above.

¹⁹⁷ See para 6.2.2.3 above.

banner. It would rather appear to be a test which involves a balancing of a number of factors which ultimately leads to a result. Of these factors, some may weigh more than others, namely the failure to observe corporate formalities, the undercapitalisation of a company, the operation of a single business entity and inequity or fraudulent conduct. What seems to be apparent from the American case law in respect of the piercing of the corporate veil is that the courts in the United States appear to be more inclined to pierce the veil than their counterparts in the United Kingdom and South Africa. The United States, however, shares the same uncertainty about the labels or tests which should be applied to the piercing the corporate veil. It would appear that in the end it comes down to the facts at hand and the tests which are used are put there *ex post facto* to justify a decision. There seems to be no coherence in the different judgments, especially where different labels are attached to facts which at face value seem similar.

In the light of the uncertainty and lack of clarity regarding the piercing of the corporate veil, the other option would be to abolish limited liability in respect of delicts committed by the subsidiary should piercing not be the answer, even in a modified form.

6.4 The abolition of limited liability: The economic argument

If there is no benefit for a company to engage in risky business activity due to the high costs involved, the company will not engage in that risky activity whether limited liability exists or not.¹⁹⁸ A sensible voluntary creditor will also only engage in (risky) activities with a borrower if he has (sufficient) information about the borrower, and in the case of a monetary relationship, about the purpose of the loan to the debtor. The information of the creditor, however, does not have to be perfect. Should the creditor have sufficient information to have a good understanding of the nature of the company and the field of its activities, the creditor is able to charge a premium for the risk. If the premium is determined correctly it becomes immaterial whether the creditor has perfect information. The market price should protect both the creditor and the debtor company in a case where a risky engagement is foreseen. If the debtor company pays the appropriate premium for

¹⁹⁸ Easterbrook & Fischel *Economic structure* 51.

the risk it will not engage in conduct which could be excessively risky.¹⁹⁹ Limited liability is therefore acceptable to a voluntary creditor because he can factor his assessment of the risk into his transaction with the company and in general is better protected than the involuntary creditor.

It was shown above that economics works with the question of efficiency.²⁰⁰ The question which will be briefly addressed here is whether the principle of limited liability ensures efficiency in respect of the damages or loss suffered by a victim of a delict caused by a company. Illustrative of the arguments advanced by certain authors, which will be discussed below, is the case of *Walkovsky v Carlton*.²⁰¹

In the *Walkovsky* case Carlton was the majority shareholder in ten companies which were horizontally integrated, i.e. all ten companies conducted exactly the same business. The business of all ten companies was that of the operation of a taxi business. Each company owned two taxis and only the minimum statutory indemnity insurance was taken out for each taxi by each company. From the facts it appeared that each company was intentionally undercapitalised for the purpose of avoiding liability for potential accidents which was a foreseeable risk for a taxi operator. All available income was also “milked” from each company to leave it with little funding.

Walkovsky was injured by a driver of the Seon Cab Company, one of the ten companies horizontally integrated. Due to the undercapitalised nature of the company and its lack of assets, Walkovsky wanted to institute legal action against the majority shareholder, Carlton, because the “multiple corporate structure constitutes an unlawful attempt to ‘defraud members of the general public’ who might be injured by the cabs.”²⁰² Carlton excepted on the basis that the averments did not constitute a cause of action. The exception failed and he appealed.

¹⁹⁹ Easterbrook & Fischel *Economic structure* 51.

²⁰⁰ See para 3.6 above.

²⁰¹ *Walkovsky v Carlton* 18 N.Y. 2d 414, 223 N.E. 2d 6, 276 N.Y.S. 2d 585.

²⁰² 416.

The Court of Appeals sets out with the premise of separate juristic personality and limited liability and that these will only be disregarded in order to avoid fraud or to avoid inequitable results. The plaintiff in essence alleged that the companies were actually all components of one entity and in effect a dummy of the shareholders. The court stated that “[t]he corporate form may not be disregarded merely because the assets of the corporation, together with the mandatory insurance coverage of the vehicle which struck the plaintiff, are insufficient to assure him the recovery sought. If Carlton were to be held individually liable on those facts alone, the decision could apply equally to the thousands of cabs which are owned by their individual drivers who conduct their businesses through corporations”.²⁰³

Undercapitalisation, the milking of assets and commingling of assets were not sufficient to pierce the corporate veil. There was nothing fraudulent about taking out the minimum insurance or organising the enterprise horizontally and therefore the veil could not be pierced. The question is therefore whether it is efficient from an economic perspective to externalise the costs of a delict from the shareholder to the victim and, in essence, to society.

Halpern *et al*²⁰⁴ use the *Walkovsky* case to illustrate why limited liability is inappropriate in respect of delictual victims. On the assumption that the law of delict is there to compensate the victim for his loss and to deter the wrongdoer from inflicting the harm which attracts liability, the authors argue that limited liability then encourages the owner not to take out insurance, since he will not be personally liable in the situation where his company caused harm.²⁰⁵ This brings about a moral hazard, namely the owner will take higher risks since he knows that he will not be held liable and this in effect promotes more irrational behaviour with possible prejudice for society.

²⁰³ 419.

²⁰⁴ Halpern, Trebilcock & Turnbull “An Economic Analysis of Limited Liability in Corporation Law” 30 *Toronto Law Journal* 117 (1980).

²⁰⁵ 145.

The authors then state that under a system of unlimited liability, the owner of several taxi companies would have three choices. He could firstly maintain sufficient personal funds to satisfy delictual claims; he could secondly take out insurance cover in his personal capacity to satisfy all delictual claims; or he could thirdly let the company take out insurance cover to guard against delictual claims. The first option is highly unlikely in light of the potentially prohibitive costs involved. The authors argue that the second and third options would in effect mean that unlimited liability and insurance cover would result in a *de facto* limited liability regime where the owner is not personally liable for the delicts of his company. This then again leads to a moral hazard.²⁰⁶

The authors nevertheless argue that there is an important difference between unlimited liability combined with insurance and limited liability. With limited liability, the shareholders take out insurance at no cost, it is the company which incurs the cost. With unlimited liability with insurance, the premiums payable have a market price which is further dependent on the behaviour of the taxi owners and drivers. The shareholders will become more careful by causing the company to employ safe drivers and to invest in training for its taxi drivers to decrease the risk and to lower the premiums. There is therefore an incentive for efficient behaviour. The authors further argue that the company is the most cost effective insurer since it has better information about taxi accidents causing harm to pedestrians than pedestrians would have. Insurance will therefore be more effectively priced by the market for a taxi company than for a pedestrian. Furthermore transaction costs will be reduced because there are incentives for the company to insure, rather than pedestrians, because fewer transactions would be involved.²⁰⁷

Hansmann and Kraakman²⁰⁸ also deal with the issue of limited liability in the field of the law of delict. The authors look at the corporate landscape and mention that the technological and industrial advances and changing norms should lead to a change in the

²⁰⁶ 145.

²⁰⁷ 146.

²⁰⁸ Hansmann & Kraakman "Toward Unlimited Shareholder Liability for Corporate Torts" 100 *Yale Law Journal* 1879 (1991).

treatment of delictual liability in the context of companies.²⁰⁹ The authors first argue that a single shareholder company, especially where that shareholder is a holding company, which is risk neutral,²¹⁰ creates incentives for inefficient behaviour.²¹¹ The inefficiency, also as identified by Halpern *et al*²¹² is that excess risk could be undertaken without taking sufficient care to avoid harm. Unlimited liability, on the other hand, would lead to efficient social costs being incurred by means of pre-emptive measures which would enable a shareholder to escape liability.²¹³ Secondly, limited liability stimulates an overexposure in harmful industries due to the externalisation of costs. This could be positive for the shareholder but its net value for society is negative.²¹⁴ Thirdly, limited liability may lead to an undercapitalisation of a company to reduce the exposure of the owner of the firm for any delictual liability.²¹⁵

Hansmann and Kraakman argue that a factor which could worsen inefficiency under a limited liability regime is the fact that the harm from hazardous activities may only appear much later and the company by then could have already been liquidated.²¹⁶ To avoid liability nobody may be interested to purchase the offending company (since the entity would remain liable despite a change in ownership) which could lead to asset stripping.

²⁰⁹ Kahan "Shareholder Liability for Corporate Torts: A Historical Perspective" 97 *Georgetown Law Journal* 1085 (2009) 1103.

²¹⁰ See Burrows & Veljanovski *The Economic Approach to Law* (1991) 196 and Posner *Economic Analysis of Law* 6ed (2003) 10-11. The latter provides the following example to illustrate the three categories of risk takers, namely the risk averse person, the risk neutral person and the risk preferent or risk seeking person. Assume person A is given the choice of receiving R1 million or a 10% chance to receive R10 million. The risk averse person would choose the R1 million. The risk neutral person, because the 10% chance to R10 million effectively means R1 million would view the choice as a fair risk and would take the chance because it is fair. The risk seeking person will purely focus on the R10 million without taking into account the chances of success. In the context of this discussion one would assume that the risk averse shareholder would expect some dividend and would rather incur costs to receive some dividend than taking the risk of a larger dividend by not incurring those costs. The risk neutral shareholder would look at the possibility of the risk and if the risk is fair he would not incur costs to avoid the risk. The value of the dividend is therefore irrelevant as long as the risk is fair. The risk averse shareholder in the context of limited liability would incur costs and therefore internalise those costs whereas the risk neutral shareholder would not necessarily internalise the costs.

²¹¹ Hansmann & Kraakman *Shareholder Liability for Corporate Torts* 1882.

²¹² Halpern, Trebilcock & Turnbull *Economic structure* above.

²¹³ Hansmann & Kraakman *Shareholder Liability for Corporate Torts* 1883.

²¹⁴ Hansmann & Kraakman *Shareholder Liability for Corporate Torts* 1883.

²¹⁵ Hansmann & Kraakman *Shareholder Liability for Corporate Torts* 1883.

²¹⁶ Consider the asbestos mining operations of Cape plc's subsidiaries in South Africa where the harm only appeared years after the liquidation of the subsidiary companies which led to costly litigation against the holding company and high social costs. See in this regard *Lubbe v Cape plc* [2000] UKHL 41 of 20 July 2000.

Theoretically, where the shareholder is risk averse and he does not have liability insurance the inefficiency due to limited liability is possibly less severe than where the shareholder is risk neutral.²¹⁷ The authors argue as follows:

“With risk neutrality, damages function only to deter harm, and for this purpose efficiency requires that the risk neutral shareholder bears the full cost of any tort damages. With risk aversion, however, tort damages can serve two different efficiency functions: they can create incentives for avoiding harm, and they can distribute risk between injurer and victim so that the less risk-averse party bears most of the risk. Choosing an efficient measure of damages commonly requires a trade-off between these two functions.”²¹⁸

Unlimited liability is an even more attractive option where liability insurance is available.²¹⁹ The shareholder, because costs are internalised, i.e. the company bears the costs, will take greater care to prevent the company from causing harm.²²⁰ Hansmann and Kraakman come to the conclusion, like Halpern *et al*, that unlimited liability would be more efficient in respect of delictual liability than limited liability, due to the internalisation of costs, which would be socially more efficient.²²¹

6.5 Alternative basis for delictual liability

Muscat is of the opinion that tort liability was not under consideration when the principle of limited liability was introduced in the United Kingdom.²²² He refers to the lack of any mention of tort creditors in the parliamentary debates on limited liability. He mentions that when limited liability was under debate, the corporations of that time could be held liable in tort and yet all debate on limited liability was restricted to the field of contract law.²²³ Muscat accepts however that one possible explanation for the lack of discussion could have been the fact that liability in tort for negligence only commenced as a separate

²¹⁷ Hansmann & Kraakman *Corporate Torts* 1886.

²¹⁸ Hansmann & Kraakman *Corporate Torts* 1886.

²¹⁹ Hansmann & Kraakman *Corporate Torts* 1888.

²²⁰ See Halpern *et al Economic Analysis* above.

²²¹ See further Hansmann & Kraakman *Corporate Torts* 1896-1899 in respect of the shareholders to whom liability would attach, i.e. shareholders at the time when the delict is committed or the shareholders who are shareholders at the time of the institution of the legal action; whether the liability should be joint and several or *pro rata* and other related matters.

²²² Muscat *The Liability of the Holding Company for the Debts of its Insolvent Subsidiaries* (1996) 178.

²²³ Muscat *Liability of the Holding Company* 179.

ground for liability in the 1820s and it was not a well-developed area of the law when limited liability for shareholders of corporations was introduced in the United States and the United Kingdom.²²⁴ Muscat therefore concludes that the undeveloped nature of liability in tort for negligence at the time and the possibility that tort liability could cause the demise of a company was then unheard of, may have contributed to limited liability only being considered in respect of contractual liability.²²⁵

It appears that limited liability for delictual liability came about by accident instead of being based on policy considerations. The principle of limited liability was a tool which was conveniently there for the judiciary to use to determine delictual liability where companies were involved. Muscat distinguishes four situations where liability should arise for holding companies in respect of torts or delicts committed by a subsidiary. These four situations are: firstly where the subsidiary company is subservient to the holding company; or secondly where the subsidiary is undercapitalised by its holding company; thirdly where there is an economic integration of the companies within a group which is abusive; and fourthly where the group in certain circumstances holds itself out as a single person. These four situations will be discussed in chapter seven in the light of the fact that the arguments of Muscat are essentially concerned with the holding company being liable for the debts of the insolvent subsidiary in the abovementioned four situations.²²⁶

A further view in respect of limited liability in the context of delictual liability is that of Kahan,²²⁷ who refers to criticism that the doctrine of limited liability leads to negative externalisation²²⁸ and therefore stimulates harmful and sometimes delictual corporate behaviour.²²⁹ Many critics of limited liability according to Kahan argue that the doctrine has no historical foundation in the field of the law of delict in common-law systems. Kahan investigates the correctness of this assumption. He argues that limited liability in

²²⁴ Muscat *Liability of the Holding Company* 180.

²²⁵ Muscat *Liability of the Holding Company* 180.

²²⁶ See para 7.8 below.

²²⁷ Kahan *Shareholder Liability* above 6.4.

²²⁸ See para 6.4 above.

²²⁹ Kahan *Shareholder Liability* 1086.

the field of the law of delict in the United States started out as a restraint on unlimited liability. The basis for this argument is that some legislatures imposed certain conditions on companies by inserting provisions in their articles that the shareholders would be liable for the debts of the company according to their shareholding. A proliferation of claims based on all sorts of causes of actions were instituted against companies, which caused the courts to interpret the word “debts” in the constitutions of companies narrowly and to apply only to contractual debts. Other courts in others states followed suit and it became the general rule.²³⁰ Limited liability eventually fortuitously became the reason for the fact that the holding company would not be liable for the delicts of the subsidiary.

It therefore appears that a number of authors argue that limited liability should not apply in the field of delictual liability but that they differ in respect of the reasons for the non-applicability of the doctrine.

6.7 Australian piercing of the corporate veil

Australian company law, like its South African counterpart, is English based. As such the shadow of *Salomon v Salomon*²³¹ looms large over these two systems. The basic premise in Australia is therefore the sanctity of the separate juristic personality which will only be pierced in exceptional cases.

Each company within the group structure is liable for its own debts²³² except where the Australian Corporations Act²³³ (“the ACC”) provides otherwise.²³⁴ In *Walker v Wimborne*²³⁵ and in *Wimborne v Brien*²³⁶ Brien was the liquidator of Langrenus Pty Ltd, the second appellant which was one of a number of companies in which Wimborne had an interest. Wimborne was married but separated from Mrs Wimborne, who sought a property settlement consequent to their separation. The shares in Langrenus were initially

²³⁰ Kahan *Shareholder Liability* 1098–1103.

²³¹ Above.

²³² *Walker v Wimborne* (1976) 137 CLR; *Wimborne v Brien* (1997) 23 ACSR 576.

²³³ 2001.

²³⁴ See para 7.5.5 below for a discussion of ss 588V and 588W.

²³⁵ Above.

²³⁶ Above.

held by Mrs Wimborne and a family trust. The trust was subsequently terminated by Mr Wimborne who then transferred the shares to himself. This led to a deadlock in the administration of Langrenus and an order for winding-up was granted on the basis that it would be just and equitable to do so despite the fact that Langrenus was solvent. Extensive litigation followed the separation between the Wimbornes including litigation involving most of the companies in the Wimborne stable. The case at hand arose out of a cross-claim filed in proceedings by Mr Wimborne, Langrenus and Estoril Investments Pty Ltd.

All the members of the Wimborne family held shares in Estoril Investments Pty Ltd. The company had incurred losses but was owed money by other companies in the group including Langrenus and Topmast Pty Ltd. The Wimborne family trust held 50% of the shares in Topmast and the balance was held by Langrenus. The debtor companies of Estoril had to pay interest on the money owed at rates which were generally below market rates. On the advice of accountants the interest rates were increased to market rates and were also backdated. Estoril could therefore absorb some of the profits of the other companies and they in turn could reduce their tax liability because of their reduced net incomes. Estoril was also indebted to Mr Wimborne who had a charge over Estoril's assets. The New South Wales Court of Appeal found that this circumstance benefited only Mr Wimborne and was to the detriment of Mrs Wimborne as a shareholder of Langrenus and of the family trust. The liquidator refused to admit the claim by Estoril in respect of the increased interest rates.

In essence a number of companies in the group owed money to other companies in the group and there was cross-shareholding in a number of cases as well. The dispute between all the parties revolved around the distribution of assets between Mr and Mrs Wimborne. The argument of Mr Wimborne was that all the companies within the group would be transferred to him in return for a cash settlement which still had to be determined. The argument was further that it did not matter which assets were in which companies provided that all the assets were preserved and that the liquidator should only have regard to the joint interests of Mr and Mrs Wimborne and the group, and do nothing apart from paying outside creditors and preserving the assets.

The basis of the appellants' claim that the respondent should only have paid the outside creditors and maintain Langrenus' assets pending the finalisation of the divorce proceedings, depended on the proposition that because of the interlocking and related shareholding of the various companies they should have been treated as a single entity and since all of them would be transferred to Mr Wimborne it did not matter which assets or liabilities were in which company.

The Court of Appeal of New South Wales, however, held that to treat the group as a single entity would have breached a fundamental concept of company law, i.e. the separate personality of each company and that there was no legal entity of a group. It was therefore the duty of Brien as liquidator of Langrenus to have regard only to its interests. The principle in *Salomon*²³⁷ was therefore applied. It has to be borne in mind that it was Mr Wimborne who created the structure of the group and then tried to ignore the structure he created when that structure was to his detriment. Here was also no fraud or dishonest conduct at hand, the single economic unit argument was the only one advanced to pierce the corporate veil.

When a company within the group structure considers the payment of a dividend to its members it may not take into the account the profits of the other companies in the group structure.²³⁸ In the *Industrial Equity Ltd*²³⁹ the court considered possible ways to pierce the corporate veil. The court first looked at the options available to pierce the corporate veil, which have been judicially recognised. These are, for example, where there was an agency relationship between the holding company and the subsidiary, in cases of fraud, and where there are group enterprises at hand. *In casu* the only possibilities available to the plaintiff were to show some agency agreement between the two relevant companies, or fraud or that the group enterprise was a single entity. On the facts, however, there could be no agency since the holding company was party to the agreement but not a party to the clause in issue.

²³⁷ See para 2.4 above.

²³⁸ *Industrial Equity Ltd v Blackburn* (1977) 137 CLR 567.

²³⁹ Above.

The plaintiff also relied on *DHN Food Distributors & Ors v London Borough of Tower Hamlets*²⁴⁰ where the economic reality of a group was recognised.²⁴¹ The court in *Industrial Equity*, however, distinguished the *DHN* case by holding that it was decided on policy reasons based on the specific facts and did not lay down any new legal principle. The court looked at the impact of the *DHN* case in the United Kingdom and New Zealand and whether it could be reconciled with Australian law.²⁴² The court rejected the plaintiff's reliance on the *DHN* case. It held that the court would lift the corporate veil only in cases where it is clear that there was *de facto* or in law a partnership between the holding company and its subsidiary, or where there was a sham or façade. *In casu* there were sound commercial reasons for having separate companies in the group performing separate functions.

In the alternative the plaintiff contended that the court should pierce the corporate veil on the basis of equity. The court referred to *Gilford Motor Co Ltd v Horne*²⁴³ and *Pennington*²⁴⁴ to answer this contention. It was mentioned that fraud would be one of the grounds to pierce the veil. In Australian corporate parlance "fraud" however seemingly has a fairly broad meaning. Fraud means that a court would in equity not allow a party to escape from his obligations by means of drawing a corporate veil if in the eyes of equity it would constitute a cloak or façade. In the *Industrial Equity* case the court found that the subsidiary company was not incorporated for the sole or dominant purpose of evading contractual duties by the holding company. The court therefore refused to treat the group of companies *in casu* as a single juristic entity.

In *Qintex Australia Finance Ltd v Schroders Australia Ltd*²⁴⁵ there was confusion as to the identity of the exact contracting party in a company group. This confusion led to damages for the defendant. On the facts it was clear to the court that any confusion as to

²⁴⁰ [1976] 3 All ER 462, para 3.10 above.

²⁴¹ See para 3.10 above.

²⁴² *In Re Securitibank Ltd (in liq) & Ors* [1978] 1 NZLR 97 and [1978] 2 NZLR 136; *Woolfson v Strathclyde Regional Council* (1978) 38 P&CR 521; *Industrial Equity Ltd & Ors v Blackburn & Ors* (1977) 137 CLR 567

²⁴³ *Gilford Motor Co Ltd v Horne* [1933] Ch 935.

²⁴⁴ *Pennington Company Law* 5ed (1985) 58.

²⁴⁵ *Qintex Australia Finance Ltd v Schroders Australia Ltd* (1990) 3 ACSR 267. The facts of this case will be referred to in more detail in para 7.1 below.

who the contracting parties were was entirely due to the lax internal controls of the defendant.

The court, however, still mentioned *obiter* that commercial realities in cases like these made the application of the law increasingly difficult. According to the court disputes during the liquidation of conglomerates often result in costly litigation in respect of the identity of the parties to contracts entered into by members of the conglomerate. This led to increased expenditure on legal costs and the resulting reduction in the dividend of creditors.

In *Briggs v James Hardie & Co Pty Ltd*²⁴⁶ an employee attempted to bring legal action not only against the company of which he was an employee but also against the holding company of his employer. The employee was out of time with his claim unless he could show that there was a cause of action available. The Court of Appeal of New South Wales therefore had to establish whether a cause of action existed against the holding company after the trial court dismissed the action on the basis that the holding company could neither be held liable on the basis of agency nor on the basis of the piercing of the corporate veil.

Two judges of the Court of Appeal referred the matter back to the court of first instance since they were of the view that there was insufficient evidence to reach a decision. The dissenting judge however held that mere control over a subsidiary would not be sufficient. He referred to cases in the United States of America which held that where the holding company dominates the subsidiary to such a point that there was no separate existence or the subsidiary was formed to circumvent the law, the corporate veil would be lifted.²⁴⁷

In *Al-Shennag v Statewide Roads Ltd*²⁴⁸ the Court of Appeal of New South Wales refers to *Ford's Principles of Corporation Law*²⁴⁹ where the authors confirm that there is no

²⁴⁶ *Briggs v James Hardie & Co Pty Ltd* (1989) 16 NSWLR 549. The case could not be accessed and the discussion is based upon Austin & Ramsay *Ford's Principles of Corporations Law* (2007).

²⁴⁷ Austin & Ramsay *Ford's Principles of Corporations Law* 142-143.

²⁴⁸ [2008] NSWCA 300, 2008 WL 4868782.

²⁴⁹ 13ed (2007).

general test for piercing the corporate veil in Australia but that three principles have been developed, namely, firstly fraud, secondly where the corporate entity is used to evade existing legal obligations and thirdly, especially in cases where a holding company and subsidiary company are involved, where the (subsidiary) company is under capitalised and generally reliant on resources of the controlling holding company or as a result of such under capitalisation is merely a sham or device.²⁵⁰ The Court of Appeal held that the holding company must first deny the subsidiary the resources to function independently. Where the subsidiary has in fact an independent existence the veil will not be pierced.²⁵¹ Mere control by the holding company is therefore not sufficient to pierce the veil.²⁵²

6.8 Conclusion

The principle of *res perit domino* provides that a person who suffers harm through his own misfortune is responsible for that harm. The law of delict however provides that a person who harms another could under certain circumstances incur liability for the loss of the person whom he harmed. It would appear that the law of delict is primarily focused on compensation for delictual victims and not as a deterrent to the delictual wrongdoer.²⁵³ This is important in the context of this dissertation since if the focus is on the victim and providing him with compensation the question of limited liability should not necessarily be a sacred doctrine. It would appear that a balance of competing interests would arise within the context of groups. On the one side one has limited liability which shields the holding company from the debts of the subsidiary company and on the other side there is the victim of the delict who should be compensated. Compensation however should only be paid by the wrongdoer. The identity of the wrongdoer is therefore of crucial importance since the law would not serve its purpose if it imposed liability on the incorrect party.

The question now is what considerations should play a role in determining whether a holding company should be held liable for the delicts of its subsidiary. Here it is

²⁵⁰ Para 42 of the case with reference to 131 – 137 of *Ford's Principles of Corporation Law*. No Australian case could be found where the corporate veil was pierced in a group context.

²⁵¹ Para 43.

²⁵² *Briggs v James Hardie & Co Pty Ltd* above.

²⁵³ Neethling, Potgieter & Visser *Deliktereg* 5ed (2006) 7.

necessary to mention that with “delict of its subsidiary” is meant delict in the strict sense, namely where all the elements for delictual liability have to be proved. Possible vicarious liability, for example, for the delicts committed by an employee during the course of his employment by the subsidiary company should, it is submitted, be distinguished from other delicts given the strict liability which the employer company incurs.

Limited liability is supported by policy considerations, namely it is a doctrine which stimulates investment and a measure of risk taking which is by and large to the benefit of society both from an economic and even a social perspective. Any liability imposed on a holding company for a delict by its subsidiary could therefore stifle investment and risk taking. Abolishing limited liability for delicts by the subsidiary company could therefore be harmful to society as a whole and lead to inefficiency in the market place. Limited liability also provides certainty. Certainty in turn stimulates investment and risk taking. Where companies have certainty as provided by limited liability they are able to plan according to a certain and fixed principle without fear of incurring liability.

On the other hand it has been shown that doubt has been cast on the legitimacy of limited liability in the context of company groups, not only from a historical perspective but also from an economic perspective.²⁵⁴ From an economic perspective the doctrine does not have the same economic advantages for a holding company as it has for a shareholder who is a natural person. Even modern authors like Hansmann and Kraakman and Halpern *et al* have doubted the efficiency of limited liability in respect of delictual liability.²⁵⁵

It is submitted that the existence of the doctrine of limited liability for a holding company has been put into serious doubt not only generally but also in respect of the law of delict. Some would argue that there is enough evidence to abolish the doctrine altogether where a group of companies is involved. However, it must be accepted that the doctrine has existed for over one hundred and fifty years and that it does play an important economic and social role. Its importance should not, however, be overestimated. In smaller

²⁵⁴ See, for example, paras 2.2.2, 2.3, 2.5, 2.6, 6.4 and 6.5 above.

²⁵⁵ See para 6.4 above.

companies and even bigger ones it has become the norm to contract out of limited liability. Except for smaller trade creditors, larger creditors like banks and project creditors will usually insist on security over the assets of a company and its holding company and also security by the management and possibly shareholders of a company before entering into business relationships with that company.²⁵⁶ Inter-company securities and cash management agreements, where the various companies within a group, bank with the same bank and contract with the bank that should there be any credit balance to the account of a company within the group it will be set off against the debit accounts of other group members, are normal.²⁵⁷ Therefore the practical relevance of limited liability, particularly from the perspective of secured creditors and directors who provide security for company debts in their personal capacities, should not be overstated.

It is submitted that the law, regarding limited liability in the context of delictual obligations, in respect of company groups should be different to the law regarding shareholders, who are natural persons, for the reasons set out above. The judiciary in South Africa, with the exception of certain decisions on labour matters, has shown itself to be very conservative towards granting a litigant the remedy of the piercing of the corporate veil. Given the reluctance of the judiciary to pierce the veil, it may be necessary for the legislature to provide the framework for a more effective piercing of the corporate veil doctrine in respect of company groups. This legislative framework should set a different standard for the piercing of the corporate veil in the company group context than that which applies where natural persons control a company.

It has been shown above that the policy reasons for limited liability in respect of shareholders who are natural persons do not necessarily apply to corporate shareholders.²⁵⁸ It is therefore submitted that holding companies should be treated differently while still accommodating the doctrine of limited liability. The doctrine still plays an important role in the economy, even if based on sentiment and not practice, and foreign investment in the country could be compromised if limited liability were to be

²⁵⁶ In the case of a smaller private company the managers and shareholders may well be the same people.

²⁵⁷ *Intramed (Pty) Ltd (in liquidation) v Standard Bank of South Africa Ltd* [2005] 1 All SA 460 (W).

²⁵⁸ See paras 2.2.2, 2.2.2, 2.3, 2.5, 2.6, 6.4 and 6.5 above.

abolished. The abolition of limited liability should therefore not be considered but some compromise between the doctrine and the need to prevent abuse of the holding company-subsidary company relationship is required, particularly in the context of delictual obligations. Abuse should be understood more broadly and not in the narrow sense as is currently the case with the piercing of the corporate veil in English and South African law.

The next question to be addressed is what principles should such legislation contain? When one considers the different approaches in respect of the piercing of the corporate veil in the United States of America they do not seem to differ fundamentally from each other. The instrumentality and alter ego tests have been shown to be broadly similar.²⁵⁹ The single-piercing tests also do not appear to bring radically different insights. Excessive control and lack of independence also appear as important considerations under the single-factor piercing tests, as do the grounds of inequity, fraud and wrongful conduct. The single economic unit test of Louisiana also does not appear to differ fundamentally from the instrumentality and alter ego tests, despite the *Pine Tree Associates v Doctors Associates*' case.²⁶⁰ This conclusion is supported by the following quotation from the *Green v Champion Insurance Company*²⁶¹ decision where the court seemingly uses the terms interchangeably and as synonyms and not as different tests:

“When determining whether a corporation is an alter ego, agent, tool or instrumentality of another corporation, the court is required to look to the substance of the corporate structure rather than its form.”²⁶²

The Australian law regarding the piercing of the corporate veil²⁶³ appears to be as conservative as the English and South African law, although the undercapitalisation of a subsidiary could be an important factor to justify piercing of the corporate veil. It is further submitted that the four categories of abuse which Muscat proposes should lead to

²⁵⁹ See para 6.2.2.3 above.

²⁶⁰ See para 6.2.2.4.3 above.

²⁶¹ See para 6.2.2.4.3 above.

²⁶² 259 of the decision.

²⁶³ See para 6.7 above.

liability for the holding company²⁶⁴ can also be accommodated under the alter ego and instrumentality tests. The subservient company is essentially a company where the holding company exerts excessive control. The undercapitalised company is also a company which does not enjoy adequate independence and excessive control is exercised by the holding company. The group persona and single economic entity categories are also in effect the holding company in disguise and therefore can be accommodated by the alter ego concept. The alter ego concept is not entirely new to the piercing the veil parlance in South Africa and has been referred to in the *Cape Pacific* case,²⁶⁵ in *Die Dros (Pty) Ltd and Another v Telefon Beverages CC*²⁶⁶ as well as by Blackman who states that:

“A company is said to have been the ‘agent’, or, perhaps more accurately, the ‘alter ego’ or ‘instrumentality’ of its controlling shareholders where it does not, in truth, carry on its own business or affairs, but acts merely in the furtherance of the business or affairs of its shareholders, in other words, its controllers do not treat it as a separate entity, at least not in the full sense. Although the form is that of a separate entity carrying on business to promote its stated objects, in truth the company is a mere instrumentality or business conduit for promoting, not its own business or affairs, but those of its controlling shareholders. For all practical purposes the two concerns are in truth one. In these cases there is usually no intention to defraud although there is always abuse of the company's separate existence (an attempt to obtain the advantages of the separate personality of the company without in fact treating it as a separate entity).”²⁶⁷

Blackman appears to treat the alter ego and instrumentality concepts as synonyms. He also subsequently refers to the possibility that different considerations could apply for the piercing of the corporate veil in certain situations, for example when the nature of the claim is delictual.²⁶⁸ It is therefore submitted that the instrumentality and alter ego concepts should be the guiding principles in any proposal for legislative reform since they could encompass all the ingredients which would justify the piercing of the corporate veil. The precise content of the two principles will however be more difficult to formulate in legislation and should probably be left to the courts to develop, based on the meanings which these concepts have acquired especially in American cases dealing with

²⁶⁴ See para 6.5 above and para 7.8 below.

²⁶⁵ See para 2.7.2 above.

²⁶⁶ *Die Dros (Pty) Ltd and Another v Telefon Beverages CC and Others* 2003 4 SA 207 (C).

²⁶⁷ Blackman “Companies” in *LAWSA* 4(1) (1995) para 46. See also Blackman, Jooste & Everingham *Commentary on the Companies Act* (2009) 1(6) 4-140-2.

²⁶⁸ Blackman *LAWSA* 4(1) para 44 with reference to *Briggs v James Hardie & Co Pty Ltd* above.

the piercing of the corporate veil. Our courts are entitled to consider foreign law.²⁶⁹ It is submitted that the German law is not an appropriate model for the reform of South African law on liability in group situations. The voluntary contract arrangement is not popular in Germany despite its existence in the *Aktiengesetz* for nearly fifty years. Furthermore the regulation of *de facto* groups is also not without problems. The German law only caters for harm to the subsidiary and it has to be shown that the detrimental instructions were issued by the holding company. The holding company then has a defence in the form of the business judgment rule.²⁷⁰ It does not appear to provide the best solution to the problem of delictual liability in the context of company groups.

It is therefore proposed that the following provision should be inserted in the new Companies Act.²⁷¹ The proposed provisions include factors based on the list of Powell.²⁷² It is tentatively suggested that the provision could be worded along the following lines:

Liability of the holding company for the delicts of its subsidiary

163(A)(1) “**Controlling company**” means a juristic person who together with a related or inter-related juristic person controls another company (the “**controlled company**”).

(2) A court may hold

- (a) a holding company and its subsidiary company, or
- (a) a controlling company and the controlled company,

jointly and severally liable, in accordance with the principles of the common law relating to delict, subject to subsections 163(A)(3) and 163(A)(4), for any loss or damage suffered by any person due to any act or omission by the subsidiary company or the controlled company at a time when the subsidiary company was a subsidiary company of that holding company or the controlled company was controlled by a controlling company, for which that subsidiary company or the controlled company is liable in delict.

- (3) For the purposes of subsection 163(A)(2) a court shall take into consideration the following factors; provided that if a person proves that more than one of those factors are present there shall be a rebuttable presumption that the holding company or controlling company are jointly and severally liable with the subsidiary company or the controlled company for any loss or damage suffered by that person:

²⁶⁹ See s 5(2) of the Companies Act 71 of 2008.

²⁷⁰ See para 4.5 above.

²⁷¹ See para 5.3.9 above regarding the statutory piercing of the corporate veil remedy. The proposed provisions include factors based above.

²⁷² See para 6.2.1.1 above.

- (i) that the subsidiary company or controlled company did not have an independent existence;
- (ii) that the holding company or controlling company exercised excessive control over the subsidiary company or company;
- (iii) that the holding company and the subsidiary company or the controlling company and controlled company formed a single economic enterprise;
- (iv) that any wrongful, fraudulent or reckless conduct in respect of the conduct of the business of the subsidiary company or controlled company took place due to the acts of the holding company or the controlling company;
- (v) that the subsidiary company or the controlled company was grossly under-capitalised at the time it became a subsidiary or a controlled company;
- (vi) that the holding company or controlling company and subsidiary companies or controlled company have directors or officers in common;
- (vii) that the holding company or controlling company pays the salaries and other expenses or losses of the subsidiary or the controlled company;
- (viii) that the subsidiary or controlled company substantially has no business except with the holding company or the controlling company or no assets except those conveyed to it by the holding company or the controlling company;
- (ix) that the holding company or the controlling company uses the property of the subsidiary or the controlled company as its own;
- (x) that the directors or officers of the subsidiary or the controlled company do not act independently in the interest of the subsidiary or the controlled company but take their orders from the holding company in the latter's interest or from the controlling company in the latter's interest;
- (xi) that the formal legal requirements regarding the subsidiary or controlled company are not observed;
- (xii) any other factor which the court deems relevant.

(4) For the purposes of subsection 163(A)(2) a holding company or controlling company shall not be held liable for any loss or damage suffered by a person due to an act or omission of an employee of the subsidiary company or the controlled company which results in vicarious liability for the subsidiary company or the controlled company under the common law.

The main points of the proposal are the following: The principle of limited liability is maintained despite the doubts from a historical and theoretical perspective as to its applicability in respect of groups of companies and delictual liability. This will promote

certainty and investor confidence. On the other hand a holding company will also be aware that it could incur delictual liability for any acts of its subsidiary company which cause loss or damage under the stated circumstances. Furthermore a person will not frivolously bring any action because he has to prove at least one of the grounds. If he only proves a single ground, he still bears the onus of showing why the holding company should be held liable. If he succeeds in proving more than one ground, the onus shifts to the holding company which will have to show that liability should not be imposed despite the existence of the proven grounds. Sufficient examples appear in our law in respect of rebuttable presumptions and this aspect will significantly alleviate the evidentiary burden which confronts a person when he wants the court to pierce the corporate veil.²⁷³

It is important that a court should still have discretion on whether or not to impose liability. It is therefore still difficult for a person to hold a holding company liable but it will be substantially easier to succeed than it is in terms of the current law. The holding company is sufficiently protected by the fact that the plaintiff still has to prove more than one of the abovementioned grounds to shift the evidentiary burden and the court still has a discretion.

In the light of the fact that the principle of limited liability is still the point of departure, a court will probably not impose liability easily. This should reassure investors and the provisions give them ample information to enable them to structure their operations accordingly. It is submitted that this proposal constitutes a sensible compromise between the abolition of limited liability and the courts' conservatism in respect of the piercing of the corporate veil in respect of company groups. The compromise is still loaded in favour of the principle of limited liability and therefore cannot reasonably be regarded as radical.

²⁷³ See for example section 70 of the Close Corporations Act 69 of 1984 and section 8 of the Insolvency Act 24 of 1936.

Chapter 7

Liability in the case of an insolvent subsidiary

7.1 Introduction

The Cork Committee on Insolvency, which was tasked to investigate possible reforms in the field of insolvency law in the United Kingdom, uses the following example to illustrate the difficulties for a creditor of an insolvent group member.¹ A holding company incorporates a wholly-owned subsidiary company which it undercapitalises. The holding company naturally is responsible for the management of the business and affairs of the subsidiary company to the advantage of the holding company and cumulatively to the prejudice of the subsidiary company. The profits of the subsidiary company are distributed to the holding company as dividends. If the subsidiary company is in need of funding the holding company provides the funding by means of loans. The subsidiary obtains further credit, under pressure of the holding company, and it obtains a good credit rating due to its membership of the group. The subsidiary then falls on hard times, becomes insolvent and goes into winding-up procedures. The holding company, as a concurrent creditor, at the very least, competes with the other creditors and a substantial proportion of the subsidiary's assets goes to the holding company which naturally refused to accept any liability for the subsidiary company's debts. The Cork Committee accepted that "a law which permits such an outcome is undoubtedly a defective law."²

The problem that appears within groups is therefore that of the insolvency of one member in the group and the resulting difficulties for that member's creditors. Under the ordinary principles of company law a creditor may only turn to his contractual debtor for the enforcement of a debt. The only circumstances where he normally could turn to its holding company, or to that debtor's fellow subsidiary, is where the holding company or fellow subsidiary, as the case may be, provided security for the debt of the debtor or bound itself as co-principal debtor to the creditor.

¹ The Cork Committee *Insolvency Law and Practice: Report of the Review Committee* Cmnd 8558 (1982) Chapter 51 (The Cork Committee Report)435.

² 436 para 1934.

The Cork Committee considered a number of “principal ideas”³ to reform the law where insolvency within company groups occurs, especially in situations as illustrated above. The Cork Committee departed from the premise that company groups are realities of the commercial world and insolvency within groups needed to be addressed.⁴ These proposals were, firstly the joint and several liability of the companies within the group for the external debts of the other companies in the group,⁵ secondly an opt-in regime,⁶ thirdly that there could be a contracting-out possibility in respect of the first proposal,⁷ fourthly liability for a company where there has been a departure from a “predetermined code of conduct”,⁸ and lastly possible liability for a group member in case of the insolvency of another group member, which liability will be determined by a court, which should have a wide discretion but still within certain parameters.⁹ The Cork Committee ultimately made no recommendations for reform since its terms of reference were restricted to insolvency law and that any proposals regarding groups would have had an effect on other areas of the law which did not fall within its terms of reference.¹⁰

Another problem which the Cork Committee identified was the possible blanket liability on holding companies for the debts of their insolvent subsidiary companies and what effect this would have on the creditors of the solvent holding company.¹¹ Not only the creditors of the holding company could be prejudiced but also the shareholders of the holding company. The creditors could at least still be protected with effective legislation which could provide for the subordination of the claims of the creditors of the insolvent company but how could the law protect the rights or positions of the shareholders of the holding company? They, after all, bought their shares in the holding company and not in

³ 436 para 1935.

⁴ “Group activity in the sense of the conduct of various businesses by a holding company through a number of subsidiaries is a Twentieth Century phenomenon. The principles of our company law and insolvency law were developed in the Nineteenth Century. It is not surprising, therefore, that some of the basic principles of company and insolvency law fit uneasily with the modern commercial realities of group enterprise.” The Cork Committee Report 434 para 1922.

⁵ The Cork Committee Report, 436 para 1935(a). See also para 7.5.3.1 above.

⁶ 436 para 1935(b). See also para 7.5.3.1 above.

⁷ 436 para 1935(c).

⁸ 436 para 1935(d).

⁹ 436 para 1935(e).

¹⁰ 439 para 1952.

¹¹ The Cork Committee Report, 438 para 1946.

the group. Here, however, different considerations apply. The shareholders of the holding company could have, or should have, been aware of the way in which the holding company exercises its power over the subsidiary company. It is submitted that blanket liability is not a suitable option but that there should only be liability in a restricted number of cases, as will be discussed later in the proposal for reform.¹²

The movement of assets within groups could also pose problems to creditors, especially in those situations where subsidiaries in a group are wholly owned by the holding company. Where a subsidiary falls upon hard times and is unable to pay its debts it would be relatively easy to move assets to a fellow subsidiary or to the holding company. The onus would then be on the creditor to prove that the relevant asset is the property of his debtor subsidiary, which may be difficult to prove given the lack of information which he will be facing as well as the fact that the relationship between the subsidiary and its holding company would not exactly be an arm's length one.

It is clear from the law as it currently stands that the creditors of a company, which forms part of a group of companies, have in principle only a claim against the company indebted to them and not against the other members of the group. In the absence of any security by the holding company for the debts of the subsidiary, the creditors of the subsidiary are therefore exposed to only having a claim against the subsidiary company. Those creditors who have the negotiating power to force a holding company, or any other company which forms part of a group of companies, to provide security by means of, for example, cross-guarantees, will naturally do so. The majority of ordinary creditors will, however, not have this bargaining tool when they enter into contracts with a company within a group of companies.

The question is therefore what could be done to regulate or change the law relating to the insolvency of a company within a group structure on the premise that something should be done to change the current position. The insolvency of a company within a group

¹² See para 7.10 below.

affects two types of creditors. Firstly there are external creditors and secondly there are other companies within the group structure which may have extended loans or entered into transactions with a company and need to be repaid. In respect of the first question the issue is whether the solvent and liquid companies in the group should be liable to the external creditors of the insolvent member of the group. The second question is whether other members of the group structure should retain their claims against the insolvent member, whether those claims should be subordinated to the claims of all the other creditors or, lastly, whether the members of a group with claims against the insolvent member should forfeit their claims.

The problem with insolvency within a group of companies is often compounded where the creditor is not entirely sure as to which member of the group it actually contracted with and then attempts to hold the holding company liable for the debts of the subsidiaries. In *Qintex Australia Finance Ltd v Schroders Australia Ltd*¹³ Schroders acted on behalf of Qintex Television Ltd (QLT) in foreign exchange transactions. It sold ¥1,2 billion which realised AUS\$11 560 693.64 on 1 August 1989. Instead of paying the proceeds into the account of QLT, it paid it into the account of the plaintiff, another member of the Qintex group of companies. Simultaneously to the instruction to sell the yen, the defendant also received an instruction to purchase ¥1,2 billion for delivery on 4 December 1989. The purchase price amounted to \$12 054 244.12 which resulted in a nett loss of \$1 377 137.60 (including the August transaction). In terms of the arrangement between the member of the Qintex group of companies, on whose behalf the forward exchange contract had been obtained, and the defendant the amount of \$1 377 137.60 became payable to the defendant.

On 4 December 1989 the defendant appropriated an amount of \$916 206.81 from a domestic account of the plaintiff and \$46 243.41 from a foreign account of the plaintiff. On 7 December 1989 the defendant appropriated AUS\$153 761.40 from another of the plaintiff's domestic accounts. The question which the court had to decide was on behalf of which group member did the defendant enter into the foreign exchange forward contracts.

¹³ *Qintex Australia Finance Ltd v Schroders Australia Ltd* (1990) 3 ACSR 267.

From the evidence before the court it would appear that there were very lax control measures in respect of the entities on whose behalf the defendant contracted. From a commercial perspective the instructions were always from the treasurers in the Qintex group who always only referred to Qintex and not the specific Qintex entity and a single client code existed for Qintex and not individual codes for each entity.

On the facts it was clear to the court that any confusion as to who the contracting parties were, was entirely due to the lax internal controls of the defendant. There was no evidence that the plaintiff, as holding company, was the contracting party nor was there any evidence that QLT acted as agent on behalf of the plaintiff.

The court, however still mentioned *obiter* that commercial realities in cases like these make the application of the law increasingly difficult. According to the court, disputes during the liquidation of conglomerates often result in costly litigation in respect of the identity of the parties to contracts entered into by members of the conglomerate. This leads to increased expenditure on legal costs and the resulting reduction in the dividend of creditors.

In respect of outsiders to the subsidiary, or the group for that matter, there are a number of possibilities which could be considered. On the assumption that creditors should be protected against abuse within groups, especially where a subsidiary company becomes insolvent, this chapter will investigate whether the South African law provides a remedy under these circumstances and, if not, whether the law in various jurisdictions addresses this potential abuse and whether any of those remedies could be applied in South Africa.

7.2 South African law

The law in South Africa will be briefly analysed to determine what remedies are available and how effective they are.

7.2.1 Remedies under insolvency law

Businesses fail for a variety of reasons. It could be due to bad management, excessive risk taking, labour problems, legislation which increases the costs of the business and which cannot be absorbed by a company or other external factors which a company's management has no control over. Where external factors cause the demise of a company the law certainly should not impose liability on the management of a company or on others who control it, like its holding company. Where a company, however, fails due to internal factors the question arises whether liability should be imposed on the previously mentioned persons. One option which could be available to a creditor of an insolvent subsidiary is to avail himself of the provisions of the Insolvency Act¹⁴ in respect of dispositions which were made prior to the liquidation of the company and which may be set aside by a court.

The purpose of insolvency law is to bring about an equitable distribution of the assets of the debtor and to achieve a *concursum creditorum*.¹⁵ This means that upon liquidation all (concurrent) creditors are treated equally and the law protects them as far as possible. Company law starts from the premise of separate juristic personality with limited liability as one of its most discernable consequences.¹⁶ The position of shareholders is therefore paramount. Upon liquidation of a company this changes and shareholders are at the back of the queue and their claims are only satisfied if there are any assets left and they are paid after the concurrent creditors. In liquidation therefore creditors rank before shareholders. The 1973 Act furthermore specifically provides that the provisions of the Insolvency Act will apply in certain cases to the liquidation of a company which is not able to pay its debts.¹⁷

¹⁴ Act 24 of 1936.

¹⁵ Sharrock, Smith & Van der Linde *Hockly's Insolvency Law* 8ed (2006) 4.

¹⁶ S 19(2) of the new Companies Act 71 of 2008.

¹⁷ S 340(1) of the Companies Act 61 of 1973 provides that "[e]very disposition by a company of its property which, if made by an individual, could, for any reason, be set aside in the event of his insolvency, may, if made by a company, be set aside in the event of the company being wound up and unable to pay all its debts, and the provisions of the law relating to insolvency shall *mutatis mutandis* be applied to any such disposition."

The Insolvency Act regulates four types of dispositions which could be set aside, namely dispositions without value,¹⁸ voidable preferences,¹⁹ undue preferences,²⁰ and collusive dispositions.²¹ Although these provisions of the Insolvency Act provide some form of relief to the creditors of the liquidated subsidiary, the protection is scant. First of all there would have had to be a disposition to the holding company, or any other company within the group. If the disposition was in the ordinary course of business and with no intention to prefer the holding company or co-subsidiary company, as the case may be,²² or the disposition was one for value²³ or did not cause the insolvency of the subsidiary²⁴ the recipient of the disposition may retain it. Even if the disposition is set aside, the creditors of the subsidiary company will most probably only have the status of concurrent creditors and will most likely receive a minimal dividend from the realisation of the assets of the subsidiary, if they receive anything at all. The ultimate aim of a creditor of a company, which forms part of a group of companies, is to have his claim paid in full by one of the solvent members of the group, if there are any and not having to be satisfied with a dividend of most probably less than 20% of his total claim.

In *Goode Durrante & Murray v Hewitt & Cornell NNO*²⁵ Fannin J said the following about an inter-group cession agreement, which was attacked as a disposition without value under the Insolvency Act:²⁶

“In this case, as I have said, the Company is one of a group of companies, and it guaranteed the obligation of another member of the same group as a result of financial pressure upon that fellow

¹⁸ S 26 of Act 24 of 1936 which essentially provides that should a debtor have made a disposition without receiving any value in return prior to the sequestration of his estate, the trustee can apply to court to have the disposition set aside subject to certain conditions.

¹⁹ S 29 of Act 24 of 1936 essentially provides that if a person whose estate has been sequestrated has paid a creditor within 6 months of the sequestration of his estate, for example, the trustee of his estate can apply to have that payment set aside unless the beneficiary of the payment can show that the payment was in the ordinary course of business and that the debtor had no intention to prefer him.

²⁰ S 30 of Act 24 of 1936 essentially provides that if the debtor, whose estate is subsequently sequestrated, paid a creditor prior to sequestration with the intention to prefer that creditor, the trustee of the sequestrated estate can apply to court to have that payment set aside.

²¹ S 31 of Act 24 of 1936 provides in essence that if a debtor and another person collude in disposing of assets, prior to the sequestration of the debtor's estate, and this disposition prejudices the creditors of the debtor, the trustee of the sequestrated estate can apply to court to have the disposition set aside.

²² S 29(1).

²³ *Langeberg Koöperasie Bpk v Inverdoorn Farming and Trading Co Ltd* 1965 2 SA 597 (A).

²⁴ S 26(1)(b).

²⁵ *Goode Durrante & Murray v Hewitt & Cornell NNO* 1961 4 SA 286 (N).

²⁶ 24 of 1936.

member, and on the parent company. On those facts, it seems to me impossible at this stage to say that no 'value' was given for there are many important benefits which such a transaction might bring to the Company, such as, for example, the continued financial stability of the whole group of companies.”²⁷

This is a highly significant statement since it implies that the court viewed the group as an economic unit. By stating that the value of the transaction was situated in the financial stability of the group, the court in effect held that a debtor could show that value in terms of the Insolvency Act need not be received by it as the direct beneficiary, but that value could be received indirectly through the benefit to the rest of the group.

This statement of the court is not tenable in the context of company law given the applicable legal principles both then and now, unless the court had been willing to hold that the group of companies was a sham and that the corporate veil should be pierced to ascertain the true character of the “group” of companies.

Langeberg Koöperasie Bpk v Inverdoorn Farming & Trading Co Ltd,²⁸ like the *Goode Durrante* case, dealt with dispositions in terms of the Insolvency Act²⁹ within the context of a group of companies. In this case the respondent stood surety for the obligations of its holding company, Standard Finance Corporation of South Africa Ltd. Upon the liquidation of the respondent the appellant attempted to prove a claim against the respondent. The liquidator averred, *inter alia*, that the grant of the suretyship constituted a disposition without value under the Insolvency Act³⁰ that should be set aside. The appellant relied on the judgment in *Goode Durrante*,³¹ namely that the suretyship gave value to the group of companies of which the respondent was part.

Beyers JA, in delivering the majority judgment, mentioned that the respondent was a member of a group of companies but that it nevertheless had a personality of its own. He further held that when a court has to consider whether a particular transaction is or is not

²⁷ 291.

²⁸ *Langeberg Koöperasie Bpk v Inverdoorn Farming & Trading Co Ltd* 1965 2 SA 597 (A).

²⁹ Above.

³⁰ Above.

³¹ Above.

in the interests of such a company it would be prudent to bear in mind the remarks of Centlivres CJ in *R v Milne and Erleigh*,³² namely that:

“The word 'group' has been used with many shades of meaning. The basic idea seems to be: An association of companies, created not by resolutions to associate but by the acts of individuals, and depending on the facts that they have a single secretary, generally itself a company, and are controlled as to the appointment of their directors, and therefore as to the administration of their affairs, by one or a few people. The persons who wield the controlling power are the only legal personae apart from the companies themselves. There is no *persona* which is the group, and there are no interests involved except the interests of the companies and the interests of the controllers. This is not mere legal technicality. No doubt it may be convenient to talk of the interests of the group, but no one could seriously think of the group as having interests distinct from those of the companies and controllers. The fact that in a group bargaining between companies may often be non-existent, because the controllers decide, does not support the idea of a single *persona* with single interests. No business man would be deceived into thinking that in a group there is, in effect, a pooling of assets and a right in the controllers to deal with assets belonging to the companies without regard to their respective interests. Those interests must be adjusted by the controllers as honest boards would agree to do if there were no group, i.e. on fair and reasonable lines, having regard to the circumstances of each transaction.”³³

The court *a quo* in the *Langeberg* case had held, after observing that the *Goode Durrante* case was decided on exception, that:

“In the case now under consideration evidence has been heard and this evidence, Mr. Schock claimed, established beyond all doubt that the disposition did not and could not have given 'continued financial stability' to the group or the Company. In my view there is force in this argument.

After considering the evidence and the arguments adduced thereon I can come to only one conclusion, and that is that this was an extraordinary transaction by which a farming company mortgaged the whole of its assets to assist another company to meet its debts. By undertaking this liability the Board achieved nothing beneficial to the Company, the advantage sought was remote and illusory, and in the result the Company was impoverished and forced into liquidation. To describe the disposition as one for value is to ignore the facts.”³⁴

³² *R v Milne and Erleigh* 1951 1 SA 791 (AD).

³³ *R v Milne and Erleigh* 827 as quoted in the *Langeberg* case 606.

³⁴ 606H-607D.

The Appellate Division was not persuaded that the findings of the court *a quo* were incorrect. It is important to note, however, that the court held that it was not unmindful of the possible implications of its conclusion upon the general acceptability to creditors of bonds over the assets of subsidiary companies, when tendered by parent companies as security for the latter's obligations. The court held that if any such bond is attacked as a disposition without value under the Insolvency Act, the enquiry must, in its view, always be whether, on the facts of the particular case, the mortgaging subsidiary company can fairly be said to have received value for the challenged disposition.

Although the Appellate Division dismissed the appeal, it would appear that it was more due to the facts at hand than the principle. It would appear that Beyers JA and Williamson JA, who wrote the dissenting judgment, tacitly acknowledged that the financial stability of a group of companies may constitute value in terms of the Insolvency Act in appropriate circumstances. This seems to imply that the court could view a group of companies as an economic unit in appropriate circumstances.

The question of value in the context of voidable dispositions under the Insolvency Act³⁵ was again considered in *Swanee's Boerdery (Edms) Bpk (In Liquidation) v Trust Bank*.³⁶ In this decision the court seemingly attempts to qualify the judgments in the *Goode*, *Durrante* and *Langeberg* cases but simultaneously does not reject the notion that the insolvent may receive value for its disposition within the context of a group.³⁷ Value in this context refers to the financial stability of the group. This case, however, did not involve a group of companies. The only common feature of the companies in this case was that they had the same shareholders, Mr and Mrs Swanepoel. Be that as it may, the court still accepted implicitly that it is conceivable that the financial stability of a group would constitute value within the context of voidable dispositions under the Insolvency Act. The court infers that it would be a question of fact by looking at all the surrounding circumstances.³⁸

³⁵ Above.

³⁶ *Swanee's Boerdery (Edms) Bpk (In Liquidation) v Trust Bank* 1986 2 850 AD.

³⁷ See 860B-E.

³⁸ 860E.

The Insolvency Act does therefore provide some relief for creditors, even if the protection is patently inadequate. The most which a creditor of an insolvent company within a group can expect is that a disposition which was made by an insolvent subsidiary to another group member may be set aside under any of the provisions regarding voidable preferences. However, there is neither a provision which would enable a creditor to seek a contribution from the holding company or another group member, nor a pooling of assets provision where the assets of the insolvent subsidiary could be pooled together with the assets of the holding company should the holding company also be insolvent. The tacit acknowledgment by the judiciary of the group principle, in recognising that the group financial stability could possibly constitute value should there be an application that the subsidiary made a disposition without value to another group member, is nevertheless significant.

7.2.2 Reckless and fraudulent trading in terms of company law

One of the options which The Cork Committee in the United Kingdom investigated, under the insolvency law reform proposals, was the wrongful trading provisions, namely that the holding company could in certain circumstances be seen as being party to the wrongful trading of its subsidiary.³⁹ This would especially be the case where the holding company issued instructions to the subsidiary company and which resulted in the subsidiary conducting its business wrongfully.⁴⁰

Although different to the wrongful trading provisions⁴¹ referred to by the Cork Committee, the 1973 Companies Act in South Africa provides something broadly similar in that:

³⁹ The Cork Committee Report 436 para 1938.

⁴⁰ The Cork Committee Report para 436-437 para 1938.

⁴¹ S 214 (1) and (2) of the United Kingdom Companies Act of 1986 provides that: "Subject to subsection (3), if in the course of the winding-up of a company it appears that subsection (2) of this section applies in relation to a person who is or has been a director of the company, the court, on the application of the liquidator, may declare that that person is to be liable to make such contribution (if any) to the company's assets as the court thinks proper.

(2) This subsection applies in relation to a person if—

(a) the company has gone into insolvent liquidation,

(b) at some time before the commencement of the winding-up of the company, that person

“When it appears, whether it be in a winding-up, judicial management or otherwise, that any business of the company was or is being carried on recklessly or with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose, the Court may, on the application of [...] any creditor [...] of the company, declare that any person who was knowingly a party to the carrying on of the business in the manner aforesaid, shall be personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company as the Court may direct.”⁴²

For the holding company to be held liable for the debts of its subsidiary under this provision of the 1973 Act, a creditor of the subsidiary company would have to show that the holding company was (i) knowingly (ii) a party to the (iii) reckless carrying on of the business of the subsidiary company, or (iv) with the intention to defraud creditors of the subsidiary company, or (v) with any other fraudulent purpose. The first two hurdles to overcome are therefore to prove that the person was (i) knowingly and (ii) a party to the anticipated mischief provided for in the section.

In *Howard v Herrigel and Another NNO*⁴³ the Appellate Division held that “knowingly” means having knowledge of the facts from which the conclusion is to be drawn that the business of the company is being conducted in a reckless manner. One does not, however, have to be aware of the legal consequences of those facts to be held liable.⁴⁴

In *Philotex (Pty) Ltd v Snyman; Braitex (Pty) Ltd v Snyman*⁴⁵ the Supreme Court of Appeal held that “knowingly” does not necessarily imply “consciousness of recklessness”.⁴⁶ This means that a person does not have to be aware of the fact that his conduct could incur liability in terms of section 424 of the 1973 Act.

knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation, and

(c) that person was a director of the company at that time;”

⁴² S 424(1).

⁴³ *Howard v Herrigel and Another NNO* 1991 2 SA 660 (A).

⁴⁴ 673I-674A

⁴⁵ *Philotex (Pty) Ltd and Others v Snyman and Others; Braitex (Pty) Ltd and Others v Snyman and Others* 1998 2 SA 138 (SCA).

⁴⁶ 143.

According to the *Howard v Herrigel* case and the *Philotex* case “party to” does not necessarily imply being actively involved in the reckless or fraudulent conduct of the business of the company. Should a person therefore be aware of the reckless or fraudulent conduct of the business and does nothing to prevent it he is in effect consenting to such conduct and would therefore fall under the term “party to”.⁴⁷

The question therefore arises whether a holding company can be party to the reckless conduct of the business of its subsidiary. One possibility that could be helpful is the concept of a *de facto* director.⁴⁸ Both the 1973 Act⁴⁹ and the new Companies Act⁵⁰ contain absolute prohibitions on juristic persons from being directors of a company. Presumably this means that a juristic person may also not be a *de facto* director of a company. As soon as a person, including a company, involves itself in the policy and direction of its subsidiary it should be recognised that the entity acts as a director. Although it would inevitably be the board of directors of the holding company which issues directives to the directors of the subsidiary company, it would be cumbersome for a creditor of an insolvent subsidiary to try first of all to recover from the subsidiary, thereafter from the directors of the holding company, on the basis possibly that they recklessly conducted the business of the subsidiary⁵¹ and only thereafter to attempt to hold the holding company liable on the basis of section 424 of the 1973 Act should he not be able to claim successfully from the previous two defendants. However, in the light of the prohibition on a juristic person from acting as a director this will not be further investigated.

Section 424 of the Companies Act of 1973 has only been used thus far to hold directors liable for the debts of the companies, although an attempt has been made to hold the auditor of a company liable as well.⁵² The leading authority is *Philotex (Pty) Ltd v*

⁴⁷ *Philotex* 143 and *Howard* 674H.

⁴⁸ See Blackman et al *Commentary on the Companies Act* (2002) 2 original service 8-4 who defines a *de facto* director as a person who acts as a director without having been lawfully appointed.

⁴⁹ S 218(1)(a).

⁵⁰ S 69(7)(a).

⁵¹ See s 424 of the Companies Act 61 of 1973.

⁵² *Powertech Industries Ltd v Mayberry & Another* 1996 2 SA 742 (W).

Snyman; Braitex (Pty) Ltd v Snyman,⁵³ where a holding company was involved but no attempt was made to hold the holding company liable. Instead the action was only instituted against the delinquent directors of the subsidiary company. Section 424 constitutes a statutory mechanism for the piercing of the corporate veil by holding the directors of the company liable for its debts.

“Recklessness” has two components namely an objective and a subjective element.⁵⁴ This point is especially important when a company incurs further debts at a stage when it is factually insolvent. The objective element requires that the conduct of the person whom the creditor seeks to hold liable must be compared to the reasonable person. If the reasonable person would not incur the debt since he knows that the debt would not be repaid, then recklessness is present.⁵⁵ The Supreme Court of Appeal in the *Philotex* case held that recklessness would also be present where objectively the reasonable person would have known that there is a strong chance of non-payment of a debt.⁵⁶ The subjective element involves the court looking at the characteristics of the person who is sought to be held liable.⁵⁷

The question therefore arises whether a holding company could knowingly be a party to the reckless conduct of business by its subsidiary, especially in a case where the latter company incurs debt at a stage when it is technically insolvent. The requirement of “knowingly” should be easily ascertainable in those cases where the same directors of the holding company sit on the board of the subsidiary. In the light of the fact that the holding company is the sole or majority shareholder it would be extremely rare for these directors not to be aware of the financial situation of the subsidiary or the manner in which the business of the subsidiary is being conducted. The greater its shareholding in the subsidiary and the smaller the group, the more easily the holding company will satisfy the “knowingly” test.

⁵³ *Philotex (Pty) Ltd v Snyman; Braitex (Pty) Ltd v Snyman* 1998 2 SA 138 (SCA).

⁵⁴ *Philotex* 143.

⁵⁵ 147.

⁵⁶ 147.

⁵⁷ In *Philotex (Pty) Ltd and Others v Snyman and Others; Braitex (Pty) Ltd and Others v Snyman and Others*, 143 the Supreme Court of Appeal held that “[the test is subjective] insofar as one has to postulate that notional being as belonging to the same group or class as the defendant.”

The more problematic aspect may be the “party to the reckless conduct of the business” test. Mere awareness of the reckless conduct of the business will probably not suffice but it would have to be shown that the holding company was party to the reckless conduct of the business. It is submitted that some form of participation in the conduct of the business of the subsidiary may be required. In *Powertech Industries Ltd v Mayberry*⁵⁸ the court held that in order to hold the auditor of the relevant company liable it had to be shown that:

“To be a 'party' to the conduct of a company's business requires an association with it in a common pursuit. That is the ordinary meaning of the word as it is used in the statute. A 'party' to the carrying on of a company's business is one who has joined with the company in a common pursuit. Generally this would include its directors and managers, all of whom are acting in common pursuit of the company's business. If the business is conducted recklessly they are liable therefor, and for good reason, as they ought not to be permitted to shield behind the limited liability accorded to the company in these circumstances. Clearly the section is aimed only at conduct which attracts liability to the company, as it is only that conduct which constitutes the mischief against which the section is aimed. The section does not extend to those who, while carrying on their own business, incidentally enable the company to carry on its business.”⁵⁹

On the basis of this statement of the court in the *Powertech* case, a plausible case may be instituted against the holding company since inevitably there would be a common pursuit. The concept of directing minds may be important here since the holding company will inevitably appoint the majority, if not all, of the directors of the subsidiary company. Can the actions of the directors, appointed by the holding company, be the actions of the holding company? Are the directors who serve on the board of the subsidiary the directing minds of the holding company?

In *Lennard's Carrying Co Ltd v Asiatic Petroleum Co Ltd*⁶⁰ the House of Lords held that:

“[A] corporation is an abstraction. It has no mind of its own any more than it has a body of its own; its active and directing will must consequently be sought in the person or somebody who for

⁵⁸ Above.

⁵⁹ 749D-G.

⁶⁰ *Lennard's Carrying Co Ltd v Asiatic Petroleum Co Ltd* [1915] AC 705, [1914-1915] All ER 280 (HL).

some purposes may be called an agent, but who is really the directing mind and will of the corporation, the very ego and centre of the personality of the corporation.”⁶¹

The “directing mind” doctrine is therefore in essence there to attribute the acts and the mental state of the persons who control a company to that company.⁶² This doctrine of the directing mind is not limited to criminal liability but also applies to delictual liability.⁶³ The question therefore is whether the holding company is the directing mind of the subsidiary. An argument could certainly be made out that the holding company directs the operations of the subsidiary. It is submitted, however, that a blanket statement to this effect cannot be made. The mere fact that the holding company may appoint all or the majority of the directors of its subsidiary could imply that the directors who are appointed are the directing minds of the holding company itself, at least in those cases where the directors are the sole shareholders of the holding company. In cases where they are not in control of the holding company and they are appointed by the holding company the argument may still be made that the holding company is the directing mind of the subsidiary.⁶⁴

It would appear that within the context of section 424 of the 1973 Act it would be difficult to impose liability on the holding company for the reckless trading of the subsidiary. One would have to argue that the conduct of business of the subsidiary had been usurped by the holding company.⁶⁵ *Prima facie* it would appear to be an easy argument to make since the directors of the subsidiary would, as a rule, be under the control of the holding company. However, for a creditor to prove reckless trading is already a difficult task. Once he has shown that there was reckless or fraudulent trading, he has to show that a person was knowingly a party to such reckless trading. In a holding company/subsidiary company relationship, a creditor will therefore have to trace back the reckless or fraudulent trading to the holding company. If one had to trace back liability one would assume that the first line of attack would be against the directors of the

⁶¹ 283.

⁶² Blackman et al *Commentary Revision Service* 4 (2007) 4-123.

⁶³ Blackman et al *Commentary* 4-123.

⁶⁴ See also *Intramed (Pty) Ltd (in liquidation) v Standard Bank of SA Ltd* [2005] 1 All SA 460 (W).

⁶⁵ Olaerts *Vennootschappelijke beleidsbepaling in geval van financiële moeilijkheden; de positie van bestuurders en aandeelhouders*, LLD thesis University of Maastricht (2007) 198.

subsidiary, then the directors of the holding company and then the holding company itself, unless one argues that the actions of the holding company and its directors are not separable but in fact one and the same action.

The above arguments may not necessarily have become a moot point, however, in the light of the provisions of the new Companies Act.⁶⁶ The new Companies Act does not contain an equivalent provision to section 424 of the 1973 Act. The new Companies Act does provide that a company may not carry on business recklessly, with gross negligence, with the intent to defraud any person or for any other fraudulent purpose⁶⁷ or under insolvent circumstances.⁶⁸ Insolvent circumstances are not defined in the new Companies Act but from the draft regulations, the term appears to mean technical insolvency.⁶⁹ The new Companies Act also provides that a person who contravenes the provisions of the new Companies Act, in this case the company itself is liable for any loss of a person due to that contravention.⁷⁰ In the context of reckless or insolvent trading by a subsidiary this could possibly imply that if the subsidiary conducts its business recklessly or trades under insolvent circumstances, the persons who allow this could be held liable. Furthermore the provision imposing liability on a person who contravenes the new Act, in the context of trading under insolvent circumstances or recklessly, should be read with other provisions in the new Companies Act, which provide that a person is guilty of an offence if he was “knowingly a party to” the insolvent trading or reckless trading.⁷¹

A problem, within the context of possible liability based upon reckless and fraudulent trading, which was identified by the Cork Committee is that of changes to the companies forming part of the group structure.⁷² Some companies may not have been part of the group structure from the start or others may have been sold off by the holding company. The answer again may be simple. In terms of the 1973 Companies Act a court has a

⁶⁶ Act 71 of 2008.

⁶⁷ Section 22(1)(a)

⁶⁸ Section 22(1)(b).

⁶⁹ Regulation 21 of the Companies Regulations draft for public comment of 26 January 2010 read with regulation 20.

⁷⁰ S 218(2).

⁷¹ S 214(1)(c)(i).

⁷² Para 1944 438.

discretion in respect of which debts would fall within the liability of the relevant persons responsible for the reckless or fraudulent trading. If the business of a company was therefore conducted in a reckless manner prior to it becoming a subsidiary of another company, and that reckless conduct ceased due to the take over and resulting change in management, there can hardly be an argument that the holding company conducted the business of the subsidiary recklessly.

Similar arguments apply where a company leaves the group. If the holding company conducted the business of the subsidiary recklessly prior to it departing the group, there could be liability imposed by the courts in respect of those debts incurred during that time. In a certain way the position is akin to a marriage in community of property. The parties bring their individual debts into the marriage and upon its dissolution the debts incurred during the marriage are for the account of both spouses jointly and severally. In the context of the holding company and a subsidiary the courts should only hold the holding company liable for those debts which were incurred during the period that the holding company conducted the business of the subsidiary in a reckless or fraudulent manner.

7.2.3 Possible delictual liability

Another option which could possibly be of assistance to a creditor of the subsidiary company is to hold the holding company delictually liable for the losses the creditor has suffered due to the holding company's association with the subsidiary company. The creditor of the subsidiary would have to prove that the wrongful and negligent actions or omissions of the holding company caused loss to him. He would have to prove the requirements of delictual liability to succeed.⁷³ The advantage of this option is that it does not require the piercing of the corporate veil, since the purpose is not to make the holding company liable for the debts of the subsidiary company. Olaerts, with reference to Bartman and Dorresteyn,⁷⁴ states in this regard that a delict by the holding company is

⁷³ See Boberg *The Law of Delict* 1 (1984) 24-25 for the requirements for delictual liability, namely wrongfulness, fault, causation, an act or omission and loss.

⁷⁴ Bartman & Dorresteyn *Van het concern* (2006) 231.

required for indirect piercing [of the corporate veil] and therefore this does not violate the principle of limited liability. The shareholder is not held liable for the debts of the [subsidiary] company but for its own debts which are the result of its delict committed against the creditors of the subsidiary company.⁷⁵

This action of a creditor would therefore be based on the pure economic loss which he suffered due to the actions of the holding company. It is submitted that it would be difficult to hold the holding company liable on this basis, due to the difficulties of establishing the wrongfulness element which the creditor of the subsidiary will have to prove. He will also have to prove that the holding company wrongfully and negligently caused him loss.

Wrongfulness in the context of an action for pure economic loss requires either proof that a subjective right has been infringed or that a duty of care has been breached.⁷⁶ It would appear that the problem with proving wrongfulness in the context of pure economic loss is the question whether there was a duty of care on the wrongdoer *vis-à-vis* the wronged. In *Arthur E Abrahams and Gross v Cohen*⁷⁷ the court held that:

“Setting the boundaries of liability *ex delicto* for causing what has come to be styled as pure economic loss not flowing from physical damage has been a major concern of Western Courts in recent times. Fear of introducing what Cardozo J in *Ultramares Corporation v Touche*⁷⁸ called 'liability in an indeterminate amount for an indeterminate time to an indeterminate class' has deterred Courts from upholding too readily claims for damages for pure economic loss unassociated with physical damage. Thus, the mere fact that the loss which has occurred was reasonably foreseeable by the defendant is not necessarily *per se* sufficient to have given rise to a legal duty to act or to abstain from acting in order to avoid the loss.

As I see the position it comes to this. A defendant may be held liable *ex delicto* for causing pure economic loss. [I]t will have to be established that the possibility of loss of that kind was

⁷⁵ Olaerts *Vennootschappelijke beleidsbepaling* 194 in the original states that: “Doordat voor indirecte doorbraak een eigen onrechtmatige daad van de moeder vennootschap vereist is, wordt met deze rechtsfiguur [...] strict genonem geen inbreuk gemaakt op het principe van de beperkte aansprakelijkheid. De aandeelhouder wordt immers niet persoonlijk aansprakelijk gesteld voor de schulden van de vennootschap maar voor zijn eigen schulden, schulden die resulteren uit een door hem jegens de crediteuren van de dochtervennootschap gepleegde onrechtmatige daad.”

⁷⁶ Boberg *Delict* 104.

⁷⁷ *Arthur E Abrahams and Gross v Cohen* 1991 2 SA 301 (C).

⁷⁸ (1931) 255 NY 170 at 179 (74 ALR 1139 at 1145).

reasonably foreseeable by him *and that in all the circumstances of the case he was under a legal duty to prevent such loss occurring*. It is not possible or desirable to attempt to define exhaustively the factors which would give rise to such a duty because new situations not previously encountered are bound to arise and societal attitudes are not immutable.”⁷⁹

The most difficult point therefore that a plaintiff in a group context has to prove is that the holding company had a legal duty not to cause him loss. The other aspects of delictual liability may not necessarily be much easier though. Of the most recent South African cases in respect of pure economic loss the most relevant, for purposes of this dissertation, is *Holtzhausen v ABSA Bank Ltd*.⁸⁰

In the *Holtzhausen* case H entered into an agreement to sell diamonds to a buyer through an agent of the buyer. He undertook to pay commission to the agent should the transaction be concluded. The agent informed H that the purchase price for the diamonds was paid into his bank account with ABSA and provided H with three telephone numbers to verify the deposit of the purchase price into his bank account. The bank account of H reflected the deposit of the purchase price. H contacted the bank manager of the branch where he held his account to ascertain whether he could proceed with the transaction, namely to deliver the diamonds and pay the commission to the agent. He told the bank manager why he needed the verification. H gave the three telephone numbers, which the agent gave to him, to the bank manager. The bank manager assured him that he could proceed with the transaction and also personally authorised the withdrawal of the commission payable by H to the agent. Fraud was subsequently discovered on the side of the agent and buyer and the bank account of H was debited with the amount paid to the agent. H now sought to recover his losses from ABSA based on the negligent misstatement of the bank manager. The court of first instance gave absolution of the instance. H appealed to the Supreme Court of Appeal. His action was based on a delictual claim for the pure economic loss which he had suffered due to the alleged negligent misstatement by the defendant bank.

⁷⁹ 307G – 309F.

⁸⁰ *Holtzhausen v ABSA Bank Ltd* 2008 5 SA 630 (SCA). Other recent cases on pure economic loss are *Brooks v Minister of Safety and Security* 2008 2 SA 397 (C), *Van der Eecken v Salvation Army Property Co* 2008 4 SA 28 (T), *McIntosh v Premier, Kwazulu-Natal* 2008 6 SA 1 (SCA), *Stewart v Botha* 2008 6 SA 310 (SCA) and *Mediterranean Shipping Co (Pty) Ltd v Tebe Trading (Pty) Ltd* 2008 6 SA 595 (SCA).

The Supreme Court of Appeal referred to *Bayer South Africa (Pty) Ltd v Frost*⁸¹ where the Appellate Division, as it then was, held that it would in principle be possible that a negligent misstatement which induced a person to enter into a contract may give rise to a delictual claim for damages by that person.⁸²

The Supreme Court of Appeal also needed to clear up any confusion created by the decision in *Lillicrap, Wassenaar and Partners v Pilkington Brothers (SA) (Pty) Ltd*⁸³ which has been misinterpreted in a number of decisions. According to the Supreme Court of Appeal it was decided in the *Lillicrap* case that no delictual claim would be possible where the negligence which was relied upon consisted of a breach of a contractual term.⁸⁴ This did not mean, however, that a person did not have the possibility to choose between two actions, one based on delict and one based on contract, should the facts allow either one of the two.⁸⁵ Since the plaintiff in the *Holtzhausen* case was not relying on a breach of a contractual obligation by the defendant bank but on a claim which he had independently of any contract with the bank, the *Lillicrap* decision was not applicable.⁸⁶

On the question of wrongfulness the Supreme Court of Appeal held the following:

“So far as unlawfulness is concerned, the following findings might be made on the evidence led thus far: That the statement by the bank manager was made in response to a serious request; that the plaintiff approached the bank manager because of his expertise and knowledge of banking matters; and that the plaintiff's purpose in making the enquiry was, to the knowledge of the bank manager, to ascertain whether he could safely proceed with the transaction. It could be inferred that the bank manager realised that the plaintiff would rely on his answer. On the evidence led thus far, it might further be found that there are no considerations of public policy, fairness or equity to deny the plaintiff a claim; that no question of limitless liability could arise; and that an unfair burden would not be placed on the manager or the bank if liability were to be imposed - inasmuch as the manager could have refused to act on the plaintiff's request and could have protected himself and the bank against the consequences of any negligence on his part by a disclaimer. [...]

⁸¹ *Bayer South Africa (Pty) Ltd v Frost* 1991 4 SA 559 (A).

⁸² 632D-F.

⁸³ *Lillicrap, Wassenaar and Partners v Pilkington Brothers (SA) (Pty) Ltd* 1985 1 SA 475 (A).

⁸⁴ 633A-B.

⁸⁵ 633H-J.

⁸⁶ 634B-C.

Of course it goes without saying that at the end of the case, the trial court might come to the conclusion that no legal duty rested upon the bank manager to take reasonable steps to ensure that any representation which he may have made, was correct.”⁸⁷

The issue highlighted by the abovementioned quotation from the *Holtzhausen* case concerns the legal duty which rests on the alleged wrongdoer *vis-à-vis* the person who has suffered pure economic loss. It would appear that South African courts are still very wary of imposing a legal duty on a person to prevent economic loss to another unless it is very clear that such a duty existed and it is submitted that this requirement may be the most difficult requirement for a plaintiff to prove.⁸⁸ Even if there is a legal duty on a holding company, a creditor of an insolvent subsidiary company will have to show that a negligent act or omission of the holding company caused him loss. It is assumed that the act would consist of an omission by the holding company to inform a creditor of the precarious financial position of the subsidiary or the failure to capitalise the subsidiary adequately. The negligence would lie in the fact that the holding company should reasonably have foreseen that the failure to inform the creditor of the subsidiary of the precarious financial position of the subsidiary or the failure to capitalise the subsidiary adequately would lead to loss for the creditor. The creditor will then also have to prove that this failure by the holding company was causally linked to the loss.

The position in South Africa is therefore that few possibilities exist for a creditor to hold the holding company liable for the debts of the subsidiary. These possibilities would seem to be mainly theoretical and the burden of proof on the creditor would be heavy to discharge. The position in other jurisdictions regarding relief for creditors of an insolvent subsidiary will be investigated with a view to establishing whether any of these could be adopted for use in South Africa.

⁸⁷ 635E-I.

⁸⁸ Compare para 7.10 below from which it appears that such a duty may arise in the context of letters of comfort.

7.3 The position in New Zealand

The New Zealand Companies Act⁸⁹ makes provision for (i) a contribution order and (ii) a pooling order by the court, in the context of a company within a group structure when it appears to the court that it will be just and equitable to do so. The court may make a contribution or pooling order on the application of the liquidator, creditor or shareholder of the company.⁹⁰ In deciding whether it is just and equitable to make such a contribution order the court must take into account a number of factors. These factors are, firstly, the extent to which a related company⁹¹ participated in the management of the company in liquidation. Secondly the court must consider the conduct of the related company towards the creditors of the company in liquidation. Thirdly, the court has to consider the degree to which the circumstances that gave rise to the liquidation of the company are due to the actions of the related company, and lastly the court has a discretion to consider any other matter it deems fit.⁹²

The requirements which need to be satisfied before a court may order a pooling of the assets of two or more related companies which are in liquidation,⁹³ are broadly speaking the same as the requirements in respect of contribution orders. The New Zealand Companies Act provides that a court must take certain factors into consideration to determine whether it is just and equitable to grant a pooling order. Firstly, the extent to which any of the related companies took part in the management of any of the other companies; secondly, the conduct of any of the related companies towards the creditors

⁸⁹ Act 105 of 1993.

⁹⁰ S 271(1)(a).

⁹¹ S 1(3) defines a related company as follows: "In this Act, a company is related to another company if—

(a) The other company is its holding company or subsidiary; or

(b) More than half of the issued shares of the company, other than shares that carry no right to participate beyond a specified amount in a distribution of either profits or capital, is held by the other company and companies related to that other company (whether directly or indirectly, but other than in a fiduciary capacity); or

(c) More than half of the issued shares, other than shares that carry no right to participate beyond a specified amount in a distribution of either profits or capital, of each of them is held by members of the other (whether directly or indirectly, but other than in a fiduciary capacity); or

(d) The businesses of the companies have been so carried on that the separate business of each company, or a substantial part of it, is not readily identifiable; or

(e) There is another company to which both companies are related;—
and related company has a corresponding meaning."

⁹² S 272(1).

⁹³ S 271(1)(b).

of any of the other companies; thirdly, the extent to which the circumstances that gave rise to the liquidation of any of the related companies are due to the actions of any of the other companies; fourthly, the extent to which the businesses of the related companies have been combined and finally the court is also granted a discretion to consider any other matter as it deems fit.⁹⁴

In the light of the fact that the New Zealand Companies Act,⁹⁵ which preceded the current Act, also provided for the pooling of assets and contribution orders, it could be deduced that the New Zealand legislature was satisfied with the manner in which the courts applied the provisions of the 1955 Companies Act. The Cork Committee expressed some reservations regarding the position of the creditors of the holding company, for example that they could stand at a disadvantage should the holding company be ordered to make a contribution in respect of the debts of the subsidiary company.⁹⁶ The creditors of the holding company naturally contracted on the basis that the assets of the company will be used only in respect of the claims of that company.⁹⁷ The financial position of a company could drastically deteriorate within a short period of time due to unforeseen external factors like natural disasters or even man-made disasters, as illustrated by the global credit crunch towards the end of 2008.

To illustrate the point in the previous paragraph, assume that holding company X is in a sound financial position but is ordered to make a contribution of R50 million in respect of the debts of its insolvent subsidiary Y. The net asset value of company X is reduced by R50 million but it is still solvent. That position can quickly change due to unforeseen circumstances which will not only prejudice the creditors of company X, but also

⁹⁴ S 272(2). There is, however also a qualification in the New Zealand Companies Act. S 272(3) provides that the mere fact that the creditors of a company in liquidation relied on the fact that another company is or was related to the company in liquidation is not sufficient to grant a contribution or pooling order.

⁹⁵ The Companies Act of 1955.

⁹⁶ 438 para 1946.

⁹⁷ The Australian Companies and Securities Advisory Committee in respect of Corporate Groups, above, refers at 121 to Farrar "Legal Issues Involving Corporate Groups" (1998) 16 *Companies and Securities Law Journal* 184 who at 197 states "If the contribution sought from a related company threatens that company's solvency, then the court must consider the equities involved affecting the creditors of that company. These creditors will rely on arguments that they have relied on the separate assets of the company when trading with it and should not be denied a full payout because of that company's relationship with another company." Equity to the creditors of the holding company is, however, not the only factor which a court must take into account. In this respect see the position adopted by the courts in the United States, para 7.4 below.

company X itself, as well as its shareholders. The company's funds have been reduced by the contribution order, which means that there are less funds available for new developments and projects. This could lead to potential job losses and smaller or no dividends for the shareholders of the company. The short-term benefit of assisting the creditors of the subsidiary could have a longer term negative impact, not only on company X but also on its creditors and other stakeholders like employees and the broader community which depend on it. The ultimate irony would be if the holding company itself is eventually liquidated due to a chain of events which started with a contribution order, even if such order was granted in circumstances which did not cause the immediate parlous financial state of the holding company but was the first little snowball which ultimately became an avalanche resulting in liquidation.⁹⁸

There have not been many cases in New Zealand where pooling orders have been granted by the courts. In *Re Dalhoff and King Holdings Ltd*,⁹⁹ Dalhoff and King Holdings Limited was a listed company on the New Zealand Stock Exchange. Among its subsidiaries were Dalhoff and King Ltd and D and K Truck Distributors Ltd. All three companies were placed in liquidation. The liquidators of respective companies applied for a pooling order in terms of the previous New Zealand Companies Act which had a similar wording to the current Act.¹⁰⁰

If the pooling orders were granted the result would be that the unsecured creditors of the holding company would receive a dividend of 90.88 cents/\$ whereas a refusal to grant a pooling order would mean that the unsecured creditors would receive 1\$. The shareholders would receive 28 cents per share in the absence of a pooling order whereas a pooling order would result in them receiving no dividend. The unsecured creditors of Dalhoff and King Ltd would receive 49.22 cents/\$ in the absence of a pooling order whereas they would receive 90.88 cents/\$ were the pooling order to be granted. The shareholders in both cases would receive no dividend. In respect of D and K Truck

⁹⁸ The counter argument is that the holding company's improper interference in the management of the subsidiary company and insufficient regard for the interests of the subsidiary's creditors led to the insolvency of the subsidiary and ultimately to that of the holding company itself.

⁹⁹ *Re Dalhoff and King Holdings Ltd* [1991] 2 NZLR 296.

¹⁰⁰ Ss 315B and 315C of the Companies Act 1955.

Distributors Ltd the unsecured creditors, like those of the holding company, would be slightly worse off¹⁰¹ if the pooling order was granted but in both cases the shareholders would receive no dividend.

At the time of the case there was little authority on pooling orders in New Zealand. The court referred to the *Re Pacific Syndicates (NZ) Ltd*¹⁰² case where all the parties to the case consented to the order and the court did not have any need to delve into the potential complexities which may have arisen, although the court did allude to them.¹⁰³

The court in the *Dalhoff and King* case held that it had the power to look at the conduct of the parties after the liquidation over and above the statutory requirements which the court needed to take into account.¹⁰⁴ The first requirement that the court needed to look at was the question of the extent to which any of the involved companies participated in the management of any of the other companies.¹⁰⁵ From the evidence it was clear that the three companies were *de facto* operated as a single entity and after the liquidation of the companies the bank account of the holding company was used for all the companies.

The second factor which the court needed to consider in terms of the previous New Zealand Companies Act was the conduct of the companies towards the creditors of any of the companies within the group structure.¹⁰⁶ Although the number of cases where accounts were not paid by the actual debtor company but by another company was not substantial, the court held that the debts were paid by the entity for whom it was convenient at any particular time. The court therefore held that if the management of the companies treated the companies as one single entity then so much more would the creditors.¹⁰⁷ The court held in this regard that:

¹⁰¹ They would receive 100 cents/\$ in the case of no pooling order and 90.88 cents/\$ were the order to be granted.

¹⁰² *Re Pacific Syndicates (NZ) Ltd* (1989) 4 NZCLC 64 757

¹⁰³ 64, 767-64, 768 of the *Re Pacific* case.

¹⁰⁴ S 315C(2) of the 1955 New Zealand Companies Act in essence provides that a court has to take into account certain factors which are the same factors as required in s 271(2) of the current New Zealand Companies Act above.

¹⁰⁵ S 315C(2)(a) of New Zealand Companies Act 1955.

¹⁰⁶ S 315C(2)(b).

¹⁰⁷ 303.

“In summary as to this aspect of the matter, it seems to me that the particular instances clearly establish that the conduct of the companies towards creditors was such as to lead to a degree of confusion on the part of creditors as to which companies were involved with what or whom. While the particular instances illustrating the various aspects in this matter upon which the applicants rely may not be of themselves of great significance or enough to justify the intervention of the Courts in terms of the section, taken together they tend to indicate a greater degree of responsibility for confusing conduct on the part of the various companies than appears from any one illustration. They lead at least towards an overall situation where the conduct of the companies may be said to have given rise to the concerns with which the section is dealing. It should not be forgotten that they are illustrations and examples [...] that a considerable degree of confusion had existed and continued to exist and arises from the continued merged operation of these companies.”¹⁰⁸

The next consideration was to what extent the conduct of one of the companies led to the liquidation of the other companies.¹⁰⁹ It was clear to the court that the companies “stood and fell” together and that the demise of one would automatically lead to the demise of the others.¹¹⁰ It was however not clear to the court that the conduct of one of the companies necessarily led to the financial difficulties of the other companies but it accepted that it was “a matter of common sense” that the actions of one of the companies must have led to the financial difficulties of the other companies.¹¹¹

The next factor which the court had to take into account was the extent to which the businesses of the various companies were combined.¹¹² Again the court focused not on individual cases of how the businesses of the various companies were commingled but rather on the combined effect which the individual cases had.

“The points raised relating to a confusion of ownership in respect of particular assets is a further illustration that the persons responsible for managing the companies did not differentiate carefully between them or their activities, nor does it appear to persons dealing with the companies. [...] There is no difficulty in ascertaining which company was intended but it illustrates the point that the separate identity and activities of the companies were not obvious to persons outside the

¹⁰⁸ 305.

¹⁰⁹ S 315C(2)(c).

¹¹⁰ 305.

¹¹¹ 305.

¹¹² S 315C(2)(d).

structure in dealing with entities within it. It does not seem to have been important which company owned what. A degree of flexibility has been preserved which may have been convenient for those operating the companies in good times but which is now extremely inconvenient for those whose duty it is to disentangle what has occurred. That difficulty supports the applicants' contentions [that there was an intermingling of the businesses of the various companies]."¹¹³

The previous New Zealand Companies Act, like the current Act, also enabled a court to take into account other factors which it deemed appropriate or relevant to determine whether or not to grant a pooling order.¹¹⁴ The first additional factor which the court considered was the issue relating to the debts within the group of companies and their validity. Were the court to refuse the pooling order the various debts would have had to be individually scrutinised and allocated to the correct entity. This would be time consuming and lead to uncertainty for the liquidators and the creditors.¹¹⁵

The position of the shareholders was also a factor which the court considered. As pointed out above the pooling of assets would have a significant impact on the shareholders of the holding company since such an order would result in them not receiving any dividends. The previous Companies Act of New Zealand also placed an express duty on a court to take cognisance of the interests of shareholders who are shareholders of only some of the companies in the group and not of all of the companies within the group.¹¹⁶ The court held that the purpose of the section was to prevent fraudulent conduct *vis-à-vis* the shareholders of one company through the conduct of another company within the group structure.¹¹⁷ Upon the facts *in casu* there was no intention to defraud or to prefer the shareholders of one company above the shareholders of others. The sole intention of conducting the businesses as a single entity was one of convenience.¹¹⁸ Despite this assessment the court still held that the shareholders of the holding company should not receive preference over the other shareholders within the group. This is strange since

¹¹³ 306.

¹¹⁴ S 315C(2)(e).

¹¹⁵ 307.

¹¹⁶ S 315B. This particular factor has been omitted from s 272(2) of the current Act.

¹¹⁷ 307.

¹¹⁸ 307.

there was never any intention by the management of the holding company to conduct the businesses of the three entities as a single enterprise so as to prefer the shareholders of the holding company. The court reasons as follows:

“It is true that DK Holdings is a public company but people who purchase shares on the stock market must make their own assessment of the ability and style of management in the companies in which they invest, and I do not think that the fact that the shares are publicly traded is a factor which should give a preference to those particular shareholders as distinct from others.”¹¹⁹

A further relevant factor for the court in respect of the position of shareholders is the balancing of interests of shareholders and creditors of a company in cases of insolvency. With reference to *Kinsela v Russell Kinsela Pty Ltd*¹²⁰ the court¹²¹ held that the interests of creditors are more important than those of the shareholders in cases of insolvency. According to the court section 315B(2) of the former Act was there to regulate the relationship between the shareholders *inter se* and not to find a balance for the competing interests of the shareholders and the creditors of a company.¹²²

The relevant section¹²³ in the former New Zealand Act, like the current Act,¹²⁴ required the court to be satisfied that it would be just and equitable to grant a pooling order having regard to the relevant factors. The court, having considered the factors discussed above concluded that a pooling order would be apposite in the circumstances:

“Taken cumulatively the various matters add up to a formidable case as far as the applicants are concerned. Looked at overall, I think it is apparent that the persons responsible for managing these companies saw them as being separate facets of one enterprise and managed them accordingly dealing with particular situations as was most convenient at the time without reference to strict legal differentiation. [I]t is hardly surprising that members of the public saw the activities of the

¹¹⁹ 307

¹²⁰ In *Kinsela v Russell Kinsela Pty Ltd* (1986) 4 NSWLR 722 730 the court held that “where a company is insolvent the interests of the creditors intrude. They become prospectively entitled, through the mechanism of liquidation, to displace the power of shareholders and directors to deal with the company’s assets. It is in a practical sense their assets and not the shareholders’ assets that, through the medium of the company, are under the management of the directors pending either liquidation, return to solvency, or the imposition of some alternative administration.”

¹²¹ 307-308.

¹²² 308.

¹²³ S 315C(2).

¹²⁴ S 271 of the 1993 Act.

group of companies in the same way. The occasions where confusion undoubtedly occurred are, taken together, such as to negative any suggestion that there was mere public mistake arising out of the similarity of names. Like the persons managing the companies the public generally saw the companies as a group being run as one entity. Subsequently both receivers and liquidators have faced the same difficulty arising in part out of the history of the operations of the company and also because of the recognition that they did run as one enterprise. To separate them now would be to belatedly recognise a legal separation which has never in fact operated. It would be to prefer some creditors over others and to do so fortuitously since there does not seem to have been any principle on which the activities of the company were divided and also to fortuitously prefer certain shareholders over others. Much more significantly, it would allow shareholders who were no doubt participating in the enterprise as a whole in the case of one of the companies, to recover at the expense of the creditors. Justice and equity are terms which would normally involve equality of treatment taking into account all the surrounding circumstances. Against the background of the operations of this group of companies, I think it would be unjust and inequitable both to shareholders and creditors to allow their liquidation separately, thus preferring some fortuitously as against others and, further, separating out activities which have always in the past operated together.”¹²⁵

An interesting point which the court also had to consider was the position of one of the creditors who had a claim against one of the subsidiaries. In addition, that creditor obtained security from the holding company of that subsidiary in the form of guarantee. The creditor under normal circumstances, i.e. in the absence of a pooling order, would have had a claim against both the companies as long as it did not receive a total dividend of above 100 cents/\$. The creditor therefore requested the court to impose a condition to the pooling order in terms of which both claims would be preserved. The court looked at the intention behind the relevant section in the Companies Act and held that the intention behind pooling orders was to confirm the practice whereby various companies were managed as if they were one entity. The court further held that it would not be appropriate to preserve the separate identity of two of the companies in the group so that the creditor still had two claims. This would, according to the court, not be consistent with the order which the court granted.¹²⁶ The court does, however, accept that there

¹²⁵ 309.

¹²⁶ 311.

could be appropriate circumstances which could justify the right to preserve different grounds to claim against members of the group.¹²⁷

7.4 The United States of America

The insolvency law of the United States of America also provides for pooling orders albeit under a different name, that is substantive consolidation orders under the United States Bankruptcy Code.¹²⁸ There is, however, no specific provision as in the New Zealand Companies Act but the remedy has been developed by the judiciary. The first case which allowed a consolidation of assets order was the United States Supreme Court decision of *Sampsell v Imperial Paper & Color Corporation*.¹²⁹ Although the case dealt with the consolidation of the assets of the (natural person) shareholder and a company he controlled the same principle would apply to a holding company controlling a subsidiary company. In the *Sampsell* case a creditor of the Downey Wallpaper & Paint Co sought an order which would prioritise his claim against the company after a previous court order directed the consolidation of the assets of the Downey company and the assets of Downey, who together with his wife and son were the only shareholders of the company. The United States Supreme Court held as follows:

“That conclusion, of course, does not mean that the order consolidating the estates did, or in the absence of the respondent as a party, could determine what priority, if any, it had to the corporate assets [...]. [C]reditors of the corporation normally would be entitled to satisfy their claims out of corporate assets prior to any participation by the creditors of the stockholder. [...] Such priority, however, would be denied if the corporation’s creditors were parties to a fraudulent transfer of the stockholder’s assets to the corporation [...] where the transfer was fraudulent or where the relationship between the stockholder and the corporation was such as to justify the use of the

¹²⁷ 311. The court, however, fails to provide such an example. It merely stated: “It is conceivable that in a quite exceptional case reference to the just and equitable aspect of the section might allow sufficient latitude to accommodate the retention of two rights to claim. That is a matter which would have to be determined in an appropriate case. It is my view that the facts of this case do not give rise to any such exceptional situation and I am not therefore prepared to grant the order subject to any condition.” See also *Gulfc Investment Corporation v Hogan* 593 F.2d 921 (1979) in para 7.4 where a similar view was expressed by the United States Court of Appeals, Second Circuit.

¹²⁸ §105(a) provides that “[t]he court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, *sua sponte*, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.”

¹²⁹ *Sampsell v Imperial Paper & Color Corporation* 313 U.S. 215, 61 S.Ct. 904 (1941).

summary proceedings to absorb the corporate assets into the bankruptcy estate of the stockholder. [T]he corporation's unsecured creditors would have the burden of showing that their equity was paramount in order to obtain priority as respects the corporate assets. [T]he power of the bankruptcy court to subordinate claims or to adjudicate equities arising out of the relationship between the several creditors is complete."¹³⁰

In *Gulfco Investment Corporation and Others v Hogan*¹³¹ Gulfco had a number of subsidiaries of which two were relevant in the case. A court order was previously granted in terms of which the assets of Gulfco and its subsidiaries were consolidated and attached. The main issues on appeal were the fact that the substantive consolidation order, which the court *a quo* granted, would have resulted firstly in the secured creditors losing their secured rights, secondly the loss of guarantees which were given within the group structure and thirdly the fact that the assets and liabilities of the various companies were consolidated for reorganisation purposes. The main reasoning behind the decision of the court *a quo* to ignore the secured creditors' rights was that of accounting difficulties which arose and would arise if the rights were maintained. The accounts of the various companies within the group were so intertwined and difficult to distinguish that this fact outweighed the equitable problems which could arise for individual creditors. The trial court further held that transactions within the group were not at arm's length and were not recorded and as such it was very difficult to evaluate the financial position of each company. The court *a quo* further held that the two most important subsidiaries, Delta Mortgage Corporation and Horseshoe Development Corporation, had creditors who believed that these two companies were in fact solvent due to the accounting chaos that existed in the group.

Regarding the rights of the secured creditors the Court of Appeals, Second Circuit held:

"The earlier decision by this court in this identical case ought to have settled the proposition that secured creditors cannot be reduced to the status of unsecured creditors absent some compelling reason, like fraud, for such a drastic change. The district court has said that the security, shares in Horseshoe, will be difficult to appraise and evaluate. This, however, does not furnish a reason to classify the claim as an unsecured one. Criteria such as administrative convenience, expediency

¹³⁰ 907.

¹³¹ *Gulfco Investment Corporation and Others v Hogan* 593 F.2d 921 (1979).

and accounting difficulties are not adequate to warrant treatment of a secured creditor as an unsecured creditor. Nor is the awareness by the creditor of the existence of related corporations sufficient to destroy the creditor's security absent circumstances like fraud. The Pratts are not entitled to have their security, that is, the shares of Horseshoe, destroyed because such action happens to be convenient or because such action avoids accounting or valuation difficulties. Thus the consolidation order is not to be used in order to destroy otherwise valid security in Horseshoe stock. The general rule is that when a person sells his shares in the corporation he is entitled to payment and he is entitled to pursue whatever security may have been taken."¹³²

In respect of the question of intra-group guarantees the court held that the creditor would only have one claim.¹³³

In *Soviero v Franklin National Bank of Long Island*¹³⁴ the holding company was Raphan Carpet Corporation and it had a number of subsidiary companies. The holding company went into bankruptcy and a consolidation order was sought in respect of the assets of the subsidiary companies. The holding company took responsibility for the expenses and organisation of its subsidiaries. The holding company furthermore informed creditors that the holding company and the subsidiaries were a single enterprise and issued a consolidated financial statement which listed the assets and liabilities of the whole group as that of the holding company. If one of the subsidiary companies incurred losses the holding company would stand in for the losses and in the majority of cases the holding company accepted liability for the rental agreements of the subsidiaries and in some cases also paid the rental of the subsidiaries. It was clear from the facts that the subsidiaries and the holding company were in effect one company and thus the liquidator wanted to consolidate the assets of all the companies within the group structure.

¹³² 927.

¹³³ The court (at 928) held that "[o]nce the consolidation has been ordered the subject guarantees, which represent multiple claims, are necessarily eliminated. Therefore, a [previously secured] creditor has only one claim per transaction to be satisfied from the pooled resources. The court was not authorized to eliminate the guarantees running to ICB and the Pratts absent compelling equitable reasons for doing so. It would depend on a consolidation as well." The effect is the same as in the New Zealand decision of *Re Dalhoff and King Holdings Ltd*, para 7.3 above, namely that a creditor would only have one claim and could not claim on the main debt as well as on the security which had been provided.

¹³⁴ *Soviero v Franklin National Bank of Long Island* 328 F.2d 446 (1964).

The court in the *Soviero* case therefore held as follows in respect of whether a consolidation of assets should be granted:

“It is difficult to imagine a better example of commingling of assets and functions and of the flagrant disregard of corporate forms than as here demonstrated by the bankrupt. One gains the distinct impression that the bankrupt held up the veils of the fourteen collateral corporations primarily, if not solely, for the benefit of the tax gatherer, but otherwise completely disregarded them. Even Salome's could not have been more diaphanous. On these facts, we are convinced that the claims of individual corporate entities advanced for the Affiliates and Realty are ‘without color of merit, and a mere pretense’.”¹³⁵

In *Chemical Bank New York Trust Company v Kheel*¹³⁶ the facts showed that a certain Kulukundis controlled all the companies which found themselves in bankruptcy, that the companies were operated as a single economic enterprise, that funds were moved to and fro among the several companies under the control of Kulukundis and various facts indicated scant regard for the separate corporate existence of the companies. The liquidators of the various companies sought a consolidation order in respect of all the assets and liabilities of the various companies under the control of Kulukundis. The bank in this case was, however, apprehensive about its secured claim, a mortgage, which it had against one of the companies in question. The court held that:

“The power to consolidate should be used sparingly because of the possibility of unfair treatment of creditors of a corporate debtor who have dealt solely with that debtor without knowledge of its interrelationship with others. Yet in the rare case such as this, where the interrelationships of the group are hopelessly obscured and the time and expense necessary even to attempt to unscramble them so substantial as to threaten the realization of any net assets for all the creditors, *equity is not helpless to reach a rough approximation of justice to some rather than deny any to all.*

By the order of consolidation, in effect the intercompany claims of the debtor companies are eliminated, the assets of all debtors are treated as common assets and claims of outside creditors against any of the debtors are treated as against the common fund, eliminating a large number of duplicative claims filed against several debtors by creditors uncertain as to which debtor was eventually liable.”¹³⁷

¹³⁵ 448.

¹³⁶ *Chemical Bank New York Trust Company v Kheel* 369 F.2d 845 (1966).

¹³⁷ 847, my italics.

The court therefore held that the consolidation order was an appropriate one, apparently on the basis that the appellant, and in fact other creditors, viewed the companies in the Kulukundis stable as a single company.

The Court of Appeals, Second Circuit, again had to decide on the issue of the consolidation of assets in *In Re Augie/Restivo Baking Company Ltd v Augie/Restivo Baking Company Ltd*.¹³⁸ Augie and Restivo were initially two unrelated entities. Union Savings Bank was the principal lender to Augie and Manufacturers Hanover Trust Company (MHTC) was the principal lender of Restivo. Restivo and Augie entered into an agreement on 27 November 1984 in terms whereof Restivo would purchase all the shares in Augie and Augie would receive fifty percent of the shares in Restivo. Augie retained ownership over all its assets. Union Bank was not aware of the negotiations and a few weeks prior to the agreement lent an amount of money to Augie and the inventory, equipment and accounts receivable of Augie served as security for the loan. In due course Augie was wound up and Restivo became the sole operating company with a single set of books and issuing financial statements under the name of Augie/Restivo. Augie was, however, not dissolved. MHTC extended further credit to the new entity and received a guarantee from Augie in respect of certain property of Augie. Bankruptcy of Augie/Restivo followed in April 1986. The consolidation of assets was ordered by the trial court which was to the detriment of Union Bank since it effectively subordinated the claim of the bank that arose a few weeks prior to the November 1984 agreement to the claim of MHTC. Union Bank therefore appealed the decision of the court *a quo*.

The Appellate Court's point of departure was to look at the purpose of the consolidation of assets, namely the equitable treatment of all the creditors of the different entities whose assets and liabilities had been consolidated. The Court of Appeals referred to a

¹³⁸ *In Re Augie/Restivo Baking Company Ltd v Augie/Restivo Baking Company Ltd* 860 F. 2d 515 (1998).

number of cases¹³⁹ where the consolidation of assets was considered by the courts. From these cases the Court of Appeal concluded that a consolidation of assets would be granted where “creditors dealt with the entities as a single economic unit” and where “the affairs of the debtors are so entangled that consolidation will benefit all creditors.”¹⁴⁰

The court *in casu* first looked at the single economic unit argument. It held that:

“With regard to the first factor, creditors who make loans on the basis of the financial status of a separate entity expect to be able to look to the assets of their particular borrower for satisfaction of that loan. Such lenders structure their loans according to their expectations regarding that borrower and do not anticipate either having the assets of a more sound company available in the case of insolvency or having the creditors of a less sound debtor compete for the borrower's assets. Such expectations create significant equities. Moreover, lenders' expectations are central to the calculation of interest rates and other terms of loans, and fulfilling those expectations is therefore important to the efficiency of credit markets. Such efficiency will be undermined by imposing substantive consolidation in circumstances in which creditors believed they were dealing with separate entities”.¹⁴¹

Based on the above statement the Court of Appeals held that the consolidation of assets was not justified *in casu* because Union provided loans to Augie solely on the financial position of Augie and at the time that the specific loan in question was made, Union was unaware of the negotiations between Augie and Restivo. MHTC also was under the impression that it dealt with two separate entities. The court then held that “[g]iven these circumstances, the fact that the trade creditors may have believed that they were dealing with a single entity does not justify consolidation.”¹⁴²

¹³⁹ *In re Continental Vending Machine Corp.*, 517 F.2d 997, 1001 (2d Cir.1975), *James Talcott, Inc. v. Wharton, Trustee*, 424 U.S. 913, 96 S.Ct. 1111, 47 L.Ed.2d 317 (1976); *Flora Mir*, 432 F.2d 1060, *Kheel*, 369 F.2d 845, (*In re Donut Queen, Ltd.*, 41 B.R. 706 (Bankr.E.D.N.Y.1984), *In re Richton Int'l Corp.*, 12 B.R. 555 (Bankr.S.D.N.Y.1981), *In re Food Fair*, 10 B.R. 123 (Bankr.S.D.N.Y.1981), *Flora Mir*, 432 F.2d at 1062-63; *Kheel*, 369 F.2d at 847; *Soviero v. Franklin Nat. Bank*, 328 F.2d 446 (2d Cir.1964), *In re D.H. Overmyer*, 2 B.C.D. 412 (Bankr.S.D.N.Y.1976), *Kheel*, 369 F.2d at 847; *Commercial Envelope*, 3 B.C.D. at 649-52.

¹⁴⁰ 518.

¹⁴¹ 518-519.

¹⁴² 519.

The court then looked at the second basis for consolidation, namely where there was a commingling of the businesses of the different companies as well as their assets. In this respect the court cautioned against reflex reactions holding:

“Resort to consolidation in such circumstances, however, should not be Pavlovian. Rather, substantive consolidation should be used only after it has been determined that all creditors will benefit because untangling is either impossible or so costly as to consume the assets. Otherwise, for example, a series of fraudulent conveyances might be viewed as resulting in a ‘commingling’ that justified substantive consolidation. That consolidation, because it would eliminate all inter-company claims, would prevent creditors of the transferor from recovering assets from the transferee. Commingling, therefore, can justify substantive consolidation only where ‘the time and expense necessary even to attempt to unscramble them [are] so substantial as to threaten the realization of any net assets for all the creditors,’ *Kheel*, 369 F.2d at 847; *Commercial Envelope*, 3 B.C.D. at 648, or where no accurate identification and allocation of assets is possible. In such circumstances, all creditors are better off with substantive consolidation.”¹⁴³

The court *a quo* ordered a consolidation of assets of Augie and Restivo on the basis that a merger between the two companies had taken place. The Court of Appeals rejected this since there was no legal merger due to the fact that the relevant merger laws of New York were not complied with, both companies continued to exist, i.e. neither was dissolved and lastly the assets of Augie were never transferred.¹⁴⁴ There was also not a *de facto* merger according to the Court of Appeals.

The court *a quo* held further that the consolidation would be to the benefit of the creditors of the two companies. The Court of Appeals rejected this view. It held that in the absence of the commingling of assets and the businesses of the two companies and where the creditors provided loans to the entities with the knowledge that they were two separate entities, the court cannot grant a consolidation order.¹⁴⁵ It is clear the court here looked at the consolidation of assets as an exception and that there should be facts to support a consolidation order. In the absence of *indiciae* pointing to consolidation it would not be equitable to order a consolidation of assets.

¹⁴³ 519.

¹⁴⁴ 519.

¹⁴⁵ 520.

Equity or fairness to (all) creditors would appear to be the ultimate goal of a consolidation order but the order must also be based on certain criteria. Equity itself would not be sufficient as illustrated by the *Augie/Restivo* case. The *Augie/Restivo* decision confirmed the approach of the court in *In re Commercial Envelope Manufacturing Co Inc, Business Envelope Manufacturers Inc, Business Envelope Manufacturers of Tennessee Inc, Business Envelope Manufacturers of California Inc*¹⁴⁶ where the consolidation of the assets of related entities was also sought. On the facts before the court there was a clear commingling of the assets and businesses of the various related entities which made it (virtually) impossible to distinguish between the assets and businesses of the respective entities. The court held that there should be a balancing of interests between some creditors who would be prejudiced by a consolidation order and the interests of those creditors who would be favoured by a consolidation. It referred to the *Chemical Bank New York Trust Company v Kheel*¹⁴⁷ case and specifically the passage which held that it would be better to “reach a rough approximation of justice to some rather than deny any to all.”¹⁴⁸

In *In re Lewellyn*¹⁴⁹ an application was brought before the Bankruptcy Court for the substantive consolidation of the estates of Lewellyn and GV Lewellyn & Company Inc. From the facts it appeared that there was no distinction made by Lewellyn between his personal business and assets and those of the company he controlled. There was a commingling of funds and a virtual impossibility to decipher the accounts of both the shareholder and the company. With reference to a number of cases¹⁵⁰ the court held that there should firstly be a need to consolidate and secondly it must be shown that substantive consolidation would be fair to creditors. With reference to the *Chemical Bank*

¹⁴⁶ *In re Commercial Envelope Manufacturing Co Inc, Business Envelope Manufacturers Inc, Business Envelope Manufacturers of Tennessee Inc, Business Envelope Manufacturers of California Inc* 1977 Bankr. Lexis 15, 14 Collier Bankr. Cas. (MB) 191; 3 Bankr. Ct. Dec 647 in the United States Bankruptcy Court for the Southern District of New York.

¹⁴⁷ Above.

¹⁴⁸ 24 with reference to the passage at 847 of the *Chemical Bank* case.

¹⁴⁹ *In re Lewellyn* 26 B.R. 246 (US Bankruptcy Court, Southern District Iowa 1982).

¹⁵⁰ *Inter alia* the *Chemical Bank* above, *Commercial Envelope* above and the *Soviero* case.

*v Kheel*¹⁵¹ case where there was one creditor who objected to the consolidation of assets based on the fact that he relied solely on the credit of one entity and not on that of the group, the court in *Llewellyn* referred to an opinion of one of the judges in the *Chemical Bank* case who stated that “equality among creditors who have lawfully bargained for different treatment is not equity but its opposite.”¹⁵² Based on all the available facts it was clear to the court that the consolidation of assets outweighed any prejudice there may have been to individual creditors of any of the parties in the bankruptcy proceedings.¹⁵³

The Federal Court of Appeals for the Third Circuit, in *In Re Owens Corning*,¹⁵⁴ had the opportunity to settle the apparent mess in which the bankruptcy courts had found themselves in respect of consolidation orders. In this case the holding company was Owens Corning of Delaware (OCD), which was in the asbestos business and had a number of subsidiary companies, each incorporated for a specific reason. Each subsidiary observed the required governance requirements and the financial statements and business records of intercompany transactions were all, by and large, properly kept and maintained. There was no state of confusion between the different sets of accounting records as in other cases where consolidation was ordered. In 1997 the holding company sought a \$2 billion loan which was granted by a consortium of banks, amongst others Credit Suisse First Boston. The subsidiary companies of OCD had to provide guarantees for this loan to serve as security. The banks took special care to protect their securities by the subsidiaries by limiting the manner in which the holding company could deal with its subsidiaries. The holding company could, for example, not enter into transactions with its subsidiaries which would cause losses for the respective subsidiary companies. The subsidiary companies also gave undertakings to operate as separate legal entities and to comply with all the governance requirements, including financial requirements. Subsidiaries could also not merge with other subsidiaries nor could they be merged into the holding company.

¹⁵¹ Above.

¹⁵² 251.

¹⁵³ 253.

¹⁵⁴ *In Re Owens Corning* 419 F. 3d 195 (3rd Circuit Delaware 2005).

In 2000 there was increased litigation against OCD based on asbestos related injuries. The holding company and a number of subsidiaries applied to reorganise their businesses in terms of the bankruptcy code. Nearly two and a half years later the relevant companies and some of the unsecured creditors came up with a reorganisation plan in terms of which substantive consolidation of the assets and liabilities of the holding company and the subsidiaries would take place. The effect of such a plan would be that all the separate guarantees of the subsidiaries would be consolidated into one obligation of the debtors as a whole. Naturally the consortium of banks opposed the proposed reorganisation plan since all their guarantees against the respective companies in the group would disappear and instead they would only have one consolidated claim against the group as a whole.

The trial court granted a consolidation order based on its conclusion that the holding company and the wholly owned subsidiaries were one company and that there was no evidence to show that the banks relied on the separate creditworthiness of each individual company when they sought their security for the \$2 billion loan. Consolidation would also, according to the court *a quo*, simplify and accelerate the whole bankruptcy process to ensure its smooth completion. The consolidation of assets and liabilities would furthermore also not render it necessary to untangle the financial affairs of all the involved companies. The consortium of banks appealed this decision.

The point of departure of the Court of Appeals was to look at the reasons for substantive consolidation. The court concluded that the power emanates from the common law and was based on equity.¹⁵⁵ It looked at the existence of the doctrine next to the piercing of the corporate veil doctrine and the remedy of setting aside dispositions which preferred certain creditors above others. It started off with the *Sampsell* case¹⁵⁶ and then also referred to the differences between the substantive consolidation order and the piercing of the corporate veil doctrine.

“Piercing the corporate veil’ makes shareholders liable for corporate wrongs. Equitable subordination places bad-acting creditors behind other creditors when distributions are made.

¹⁵⁵ 205.

¹⁵⁶ Above.

Turnover and fraudulent transfer bring back to the transferor debtor assets improperly transferred to another (often an affiliate). Substantive consolidation goes in a direction different (and in most cases further) than any of these remedies; it is not limited to shareholders, it affects distribution to innocent creditors, and it mandates more than the return of specific assets to the predecessor owner. It brings all the assets of a group of entities into a single survivor. Indeed, it merges liabilities as well. ‘The result,’ to repeat, ‘is that claims of creditors against separate debtors morph to claims against the consolidated survivor.’ The bad news for certain creditors is that, instead of looking to assets of the subsidiary with whom they dealt, they now must share those assets with all creditors of all consolidated entities, raising the specter for some of a significant distribution diminution.”¹⁵⁷

The court looked at the *Augie/Restivo* case¹⁵⁸ and *In re Auto-Train*¹⁵⁹ to determine the bases of the decisions which ultimately led to other courts following these two decisions. The basis of the *Augie/Restivo* decision was that substantive consolidation would be granted by the court in those cases where creditors contracted with the group on the basis that it was a single entity or where the business affairs of the respective companies were so intertwined and entangled that a substantive consolidation order would be to the benefit of all the creditors.¹⁶⁰ The court in the *Auto-Train* case held that substantive consolidation would be granted where use was made of the “substantial identity” of the companies in the group test, regardless of the fact that the creditors did not rely or view the entities as a single one but that the advantages of consolidating the assets and liabilities outweighed the possible disadvantages.¹⁶¹

The court *in casu* rejected the *Auto-Train* decision since this would not be equitable. If a creditor relied on the separate juristic personality of an entity “consolidation cannot be justified *vis-à-vis* the claims of that creditor.”¹⁶² The court also rejected the checklist approach which a number of courts have adopted when confronted with an application for substantive consolidation.

¹⁵⁷ 206.

¹⁵⁸ Above.

¹⁵⁹ *In re Auto-Train* 810 F.2d 270 (D.C. Circuit 1987).

¹⁶⁰ 207-208 with reference to the *Augie/Restivo* decision 518.

¹⁶¹ 208 with reference to the *Auto-Train* decision 276.

¹⁶² 210.

“Too often the factors in a checklist fail to separate the unimportant from the important, or even to set out a standard to make the attempt. This often results in rote following of a form containing factors where courts tally up and spit out a score without an eye on the principles that give the rationale for substantive consolidation (and why, as a result, it should so seldom be in play). (‘Differing tests with a myriad of factors run the risk that courts will miss the forest for the trees. Running down factors as a check list can lead a court to lose sight of why we have substantive consolidation in the first instance [...] and often [to] fail [to] identify a metric by which [it] can [...] [assess] the relative importance among the factors. The [...] [result is] resort to ad hoc balancing without a steady eye on the [...] [principles] to be advanced’).”¹⁶³

The court instead held that there are certain overarching principles which should be taken into account when a court is requested to order a substantive consolidation of the assets and liabilities of (related) entities. These principles include: the limitation of liability by respecting entity separateness as the point of departure and that courts should respect entity separateness unless there were compelling circumstances to ignore the separate identity of each company; the mere fact that consolidation would be beneficial to the administration of the case could not be seen as a harm where a court needed to interfere; substantive consolidation is an extreme remedy and one of last resort after considering and rejecting other remedies. The last principle is that substantive consolidation may only be used defensively to remedy the identifiable harms caused by entangled affairs. It may not be used as a sword, for example, to have as a primary purpose to disadvantage a group of creditors or to alter creditor rights.¹⁶⁴

The court then proposed that the test for substantive consolidation should be:

“The upshot is this. In our Court what must be proven (absent consent) concerning the entities for whom substantive consolidation is sought is that (i) prepetition they disregarded separateness so significantly their creditors relied on the breakdown of entity borders and treated them as one legal entity, or (ii) postpetition their assets and liabilities are so scrambled that separating them is prohibitive and hurts all creditors.”¹⁶⁵

It stated further that:

¹⁶³ 210-211, citations omitted.

¹⁶⁴ 211.

¹⁶⁵ 211.

“Proponents of substantive consolidation have the burden of showing one or the other rationale for consolidation. The second rationale needs no explanation. The first, however, is more nuanced. A *prima facie* case for it typically exists when, based on the parties' prepetition dealings, a proponent proves corporate disregard creating contractual expectations of creditors that they were dealing with debtors as one indistinguishable entity. Proponents who are creditors must also show that, in their prepetition course of dealing, they actually and reasonably relied on debtors' supposed unity. Creditor opponents of consolidation can nonetheless defeat a *prima facie* showing under the first rationale if they can prove they are adversely affected and actually relied on debtors' separate existence.”¹⁶⁶

The court then applied its own test to the facts at hand. In respect of the first basis the court held that it was clear that, when one looked at what occurred prior to the initial application for consolidation, the consortium of banks and the holding company as well always treated and viewed all the companies within the group as distinct separate juristic persons. In respect of the second basis of a commingling of assets the court also held that there was no evidence to support such an allegation.¹⁶⁷

The court then concluded with a statement as to what equity in the context of substantive consolidation means.

“Substantive consolidation at its core is equity. Its exercise must lead to an equitable result. “Communizing” assets of affiliated companies to one survivor to feed all creditors of all companies may to some be equal (and hence equitable). But it is hardly so for those creditors who have lawfully bargained prepetition for unequal treatment by obtaining guarantees of separate entities. No principled, or even plausible, reason exists to undo OCD's and the Banks' arms-length negotiation and lending arrangement, especially when to do so punishes the very parties that conferred the prepetition benefit - a \$2 billion loan unsecured by OCD and guaranteed by others only in part. To overturn this bargain, set in place by OCD's own pre-loan choices of organizational form, would cause chaos in the marketplace, as it would make this case the Banquo's ghost of bankruptcy.”¹⁶⁸

¹⁶⁶ 212.

¹⁶⁷ See 214-215.

¹⁶⁸ 216.

The court also held that the purpose behind an order ordering substantive consolidation is meant to be defensive to provide a shield. *In casu* the creditors who applied for the order were attempting to use it as a weapon to gain an advantage over other secured creditors and this was not justified.¹⁶⁹

Prior to the *Owens Corning* judgment in 2005 the position in the United States in respect of the substantive consolidation of assets was very uncertain. It would appear that courts used a number of *ad hoc* tests to reach an equitable result which led to uncertainty.¹⁷⁰ The *Owens Corning* decision has apparently brought much needed clarity and principle to the powers of the court to grant substantive consolidation orders, although it would appear that the courts will now be more circumspect before they will grant such orders.¹⁷¹ In the South African context the effect of the *Owens Corning* case could be that a consolidation order may be used in a single economic entity situation to protect the interests of concurrent creditors, but not to defeat the interests of secured creditors who had based their security on the existence of the holding company and subsidiaries as separate entities.

7.5 Australian law

7.5.1 Introduction

The law of insolvency in Australia, prior to the introduction of the Corporations Act of 2001, neither provided the statutory power to order the pooling of assets like its New Zealand counterpart¹⁷² nor the common-law power which the United States courts have

¹⁶⁹ 215-216.

¹⁷⁰ Frost “Organizational form, misappropriation risk, and the substantive consolidation of Corporate Groups” 44 *Hastings Law Journal* (1993) 449 461.

¹⁷¹ Graulich “Substantive Consolidation – a post modern trend” *American Bankruptcy Institute Law Review* (2006) 527 566.

¹⁷² See para 7.3 above.

developed.¹⁷³ It was, however, possible that a voluntary pooling of assets may take place under certain circumstances.¹⁷⁴

In *Dean-Wilcocks v Soluble Solution Hydroponics (Pty) Ltd*¹⁷⁵ the sole director, secretary and controller of both companies died and the companies were liquidated. An administrator was subsequently appointed. At the relevant meetings of the creditors of both companies it was decided to pool the assets and liabilities. All the creditors of the respective companies attended the respective meetings except for the Inland Revenue Service.

Due to the death of the sole director and controller of the two companies the liquidator found it difficult to wind up the companies. Furthermore, there was a clear commingling of the affairs of the two companies which was difficult to untangle due to the death of their controlling shareholder. The liquidator therefore applied for the pooling order in terms of the Corporations Law which provided that a court could grant an order granting the liquidator a(ny) power if such power is “just and beneficial”.¹⁷⁶

The court had a number of problems with granting an order which would provide the liquidator with the power to consolidate the assets and liabilities of the two companies. The first problem was the position of the respective concurrent creditors, namely whether the *pari passu* principle of payment would be disturbed, and if so, whether the disadvantaged creditors agreed to this. Since the Receiver of Revenue did not attend the meetings, an order could not be granted. In effect the Receiver of Revenue had to indicate that he had no objection to the proposed power of the liquidator to consolidate.¹⁷⁷

¹⁷³ The Australian Companies and Securities Advisory Committee in respect of Corporate Groups (2000) 127 and see para 7.4 above.

¹⁷⁴ The Australian Companies and Securities Advisory Committee in respect of Corporate Groups, above 127 which lists the following circumstances; group cross-guarantee arrangements, schemes of arrangement, arrangements between creditors and companies being wound up or about to be wound up, voluntary administrations and liquidations.

¹⁷⁵ *Dean-Wilcocks v Soluble Solution Hydroponics (Pty) Ltd* (1997) 24 ACSR 79.

¹⁷⁶ S 511 of the Corporations Law.

¹⁷⁷ 84.

The second problem which the court envisaged is that it would be difficult to have creditors' meetings since it would be difficult to establish which creditor is a creditor of which company. The effect would be that if there were to be a creditors' meeting it would be difficult to determine whether the requisite majority had voted in favour of a resolution or whether a person voted on a matter and he was not authorised to do so since he was not a creditor. In terms of the Corporations Law, however, the court held that it could grant an order in respect of the manner of the bankruptcy process.¹⁷⁸ Despite the problems which the court foresaw, it granted the order to the applicant on condition that the Receiver of Revenue had to consent to such order.

In *Re Charter Travel Co Ltd*¹⁷⁹ the same court and judge as in the *Dean-Wilcocks* case¹⁸⁰ had another opportunity to consider an application for the consolidation of the assets of two companies. CTC Package Holidays Pty Ltd was the subsidiary of Charter Travel Co Ltd. Both these companies in turn were subsidiaries of Black Sea Shipping Co Ltd. The two subsidiaries of Black Sea Shipping were being wound up and an order to consolidate their respective assets was sought by the respective liquidators.

The court confirmed that an order for the consolidation of two companies in liquidation would only be granted in exceptional cases where it is to the advantage of the creditors. On the facts it was clear that the respective creditors of each company were not easily discernable and even if they were, this would be a time consuming process. Consolidation would also be practical and beneficial for the creditors since expensive litigation would be avoided.¹⁸¹ Consolidation was therefore ordered.

¹⁷⁸ S 447A of the Corporations Law, as referred to by the court 84. This section, according to the court, allowed it to grant an order which it deems to be "appropriate". The court therefore rather relied on this section.

¹⁷⁹ *Re Charter Travel Co Ltd* (1997) 25 ACSR 337.

¹⁸⁰ Young, J of the the Supreme Court of New South Wales – Equity Division.

¹⁸¹ 338.

The Federal Court of Australia also had an opportunity to consider the consolidation of the assets and liabilities of companies within a group of companies in *Mentha and Others v G E Capital Ltd and Another*.¹⁸² The case involved a number of companies in the DIM Group of companies. If all the companies in the group were to be wound up it would have resulted in the unsecured creditors receiving between 0 cents and 45.7 cents in the dollar depending on which company in the group was the debtor.

The court considered part 5.3A of the Corporations Law which provided that an insolvent company could be administered in such a manner that would secure a better dividend for its creditors than would result from an immediate liquidation. The liquidators of the companies in the group were of the opinion that the most advantageous option for the creditors of the companies was to enter into an arrangement in terms of which all the assets and liabilities of the group members would be transferred to the holding company. The court approved the arrangement based on the advantage to all the unsecured creditors and the fact that the secured creditors would not lose their securities. The court, rightly, left open the question whether a consolidation order could be granted in cases of insolvent companies in liquidation, since the case at hand did not involve an application to consolidate the assets of the companies in liquidation but an order for an arrangement of the affairs of the companies.¹⁸³

Due to the lack of suitable remedies for creditors of an insolvent subsidiary company in Australian law, especially remedies against the holding company, various committees investigated possible law reform regarding the liability of the holding company for the debts of the subsidiary company. Two of these committees were the committee that produced the Harmer Report and the Australian Companies & Securities Advisory Committee. Some of the considerations and possible reforms measures of these two committees will be investigated below.

¹⁸² *Mentha and Others v G E Capital Ltd and Another* (1997) 27 ACSR 696.

¹⁸³ At 702 the court states: "One day it will be necessary to determine to what extent, if at all, a court can make a similar [pooling] order in the in the case of insolvent companies."

7.5.2 Calls for reform: the Harmer Report

As illustrated above and from the available resources it would appear that the Australian law of insolvency only recognised the pooling of assets in very limited circumstances. In depth investigations were undertaken to determine whether the New Zealand or United States models of contribution orders and pooling orders should be adopted in Australia.¹⁸⁴

There were recommendations made by the Harmer Report that courts should have the power to grant orders which would authorise contribution orders, namely orders that one company in a group must make a contribution to the creditors of an insolvent member of that company group. It was suggested that the court should take into account various factors to determine whether it was satisfied that such order was justified. These factors were:

“[T]he extent to which the related company took part in the management of the [insolvent] company;

The conduct of the related company towards the creditors of the company and;

The extent to which the circumstances that gave rise to the winding-up of the company are attributable to the actions of the related company.”¹⁸⁵

The Law Commission of Australia, however, was reported as being opposed to the proposal and its opposition was based on the following factors:

“Separate entity principle. It is a fundamental principle of company law that separate companies have separate legal entities. However, as a matter of policy, the Commission sees no reasonable objection to recommending the imposition of liability where a parent company permits its subsidiary to incur debts when insolvent.

Project financing. Financing for large resource and other projects needs to be done on a limited recourse basis, but that, under the Commission’s proposal, it would not be possible for a parent company to satisfy itself that it would not be liable for the debts of the project. However, the fact that creditors have entered into contracts on a limited recourse basis would be one of the ‘other relevant matters’ to which the court is required to have regard.

¹⁸⁴ The Australian Law Reform Commission Report 45 *General Insolvency Inquiry* (1988) hereafter called the “Harmer Report.”

¹⁸⁵ The Harmer report, para 335 146-7.

Uncertainty. Uncertainty in commercial dealings that would be created by the wide discretion given to the court would be undesirable. Lenders would be unable to ascertain the true liabilities of parent companies and could be expected to assume that at least some unguaranteed liabilities of subsidiaries should be taken into account. However, persons lending to the parent of a group of companies have regard not only to its balance sheet but to the consolidated balance sheet of the group and generally take cross-collateralised security. The Commission does not accept therefore that the suggested uncertainty would follow from its proposal. Moreover liability for a subsidiary's debts otherwise than under a guarantee would only arise in the context of the Commission's recommendations where that subsidiary was or became insolvent.

Accounts. Auditors and company directors would have enormous difficulty in producing accounts which represent a true and fair view of a parent company. However, the Commission does not accept that accounting difficulties are sufficiently serious to deter it from recommending the imposition of liability on a parent company which has permitted its subsidiary to trade while insolvent.”¹⁸⁶

In respect of pooling orders the Harmer Report recommended that the same factors for contribution orders should be adopted in respect of pooling orders.¹⁸⁷ According to the Harmer Report a pooling order would be administratively convenient where there had been a commingling of the affairs of the companies within the same group.¹⁸⁸ The proposal in respect of pooling orders, furthermore, included firstly the power of the appropriate court to appoint one liquidator to conduct the winding-up of the various companies in the group of companies which would ensure in theory a more efficient winding-up process. Secondly, the report recommended that the position of secured creditors should not be prejudiced by a pooling order. Thirdly the court should have the power to order a conditional pooling of assets where an equal distribution of assets would cause an injustice.

Subsequently in 2000, the Companies and Securities Advisory Committee on Corporate Groups¹⁸⁹ was of the view that there should be a balance between the interests of the respective creditors of the various companies within a group and those of the shareholders.

¹⁸⁶ Harmer report, para 336 147.

¹⁸⁷ Para 855 344.

¹⁸⁸ Harmer report 344.

¹⁸⁹ Para 7.1 above.

“A clearer balance of interests, and reduction of uncertainty, in pooling might be achieved by expressly providing that:

pooling orders should not affect the rights of external secured creditors to enforce their securities, except those that depend on retaining the separate identity of the group companies in liquidation. The court should retain a discretion to protect those latter creditors, where appropriate. Also, a secured creditor with an insufficient security should be able to claim as an unsecured creditor for the remaining debt from the remaining pooled assets of the group.

The court should have a discretionary power to provide for different creditors of companies in liquidation to receive different levels of return in appropriate circumstances. This power might be used, for instance, to exclude from the pooling arrangements, and uphold according to their terms, various supply or limited recourse project financing arrangements entered into with clearly identified particular group companies on arm's length commercial terms.”¹⁹⁰

Pooling orders were subsequently implemented in Australia as will be referred to below.

7.5.3 Australian Companies & Securities Advisory Committee

7.5.3.1 A possible “opt-in” provision to be considered

An option which was considered in 2000 by the Australian Companies & Securities Advisory Committee¹⁹¹ in respect of corporate groups was a statutory opt-in provision in respect of company groups with a corresponding stick and carrot approach. This regime would be entirely voluntary and permit a holding company and its subsidiary companies to decide to be treated as one entity or company. The incentive would be in the form of tax advantages where the holding company can write off the assessed losses of the subsidiary company or companies.

Advantages in terms of labour law could also be offered by a similar proposal in a South African context. For example, should the business of one subsidiary be transferred to a fellow subsidiary or to the holding company, there would be no transfer of an

¹⁹⁰ Para 6.93 of the report, above.

¹⁹¹ Above.

undertaking for purposes of section 197 of the Labour Relations Act.¹⁹² A retrenchment exercise pursuant to a transfer of an undertaking is automatically unfair in terms of the Labour Relations Act.¹⁹³ If the companies within a group, however, form one entity, there would be no transfer and a retrenchment exercise would not be automatically unfair, since the employees would remain with the same employer. The stick part of this approach for the holding company would be a provision similar in nature to the statutory liability of directors of personal liability companies.¹⁹⁴

A statutory provision to give effect to this approach, on an opt-in basis, could read as follows:

“A holding company may provide in its Memorandum of Incorporation that it shall be jointly and severally liable, together with a named subsidiary company, for such debts and liabilities of the subsidiary company as are or were contracted during the period that the subsidiary was a subsidiary company of that holding company.”

This approach only focuses on contractual debts and not delictual liability, criminal liability or any statutory obligations.¹⁹⁵ The reason for this restriction is that these debts would be, to an extent, under the control of the holding company, unlike debts in the case of delictual creditors. It is therefore a deterrent to opt into a system of a single entity, but on the other hand the extent of the liability is largely under the control of the holding company which is then aware of the possible future risks. The proverbial carrot of tax relief may then just be sufficient to justify incurring the risk of joint and several liability with the subsidiary company for the debts of the subsidiary company. However, it has been shown that this option is not popular in Germany and it is doubtful whether it would

¹⁹² 66 of 1995. Section 197 of the South African Labour Relations Act essentially protects employees when a business or undertaking is being transferred. The section protects employees in such circumstances by providing that the contracts of employment will be automatically transferred.

¹⁹³ S 187(1)(g).

¹⁹⁴ S 19(3) of the new Companies Act provides that: “If a company is a personal liability company the directors and past directors are jointly and severally liable, together with the company, for any debts and liabilities of the company as are or were contracted during their respective periods of office.” S 53(b) of the 1973 Companies Act essentially provides the same.

¹⁹⁵ See the following cases under s 53(b) of the 1973 Companies where the courts have, among other findings, held that the debts which the section refers to are restricted to contractual debts: *Fundstrust (Pty) Ltd (In Liquidation) v Van Deventer* 1997 1 SA 710 (A); *Sonnenberg McCloughlin Inc v Spiro* 2004 1 SA 90 (C); *Maritz v Maritz & Pieterse Inc (In Liquidation)* 2006 3 SA 481 (SCA).

be viable in South Africa, since the possible advantages appear to be outweighed by the potential risks of liability.¹⁹⁶

7.5.3.2 Breach of fiduciary duties

Another possibility which the Australian Companies & Securities Advisory Committee considered, which is not restricted to cases of insolvency, is the setting aside of agreements between the subsidiary company and the holding company or other companies within the group, on the basis that those agreements constitute a breach of the fiduciary duties of the directors of the subsidiary company.¹⁹⁷ A breach of a fiduciary duty by a director provides a company with a number of remedies, depending on the agreement which gave rise to the breach of the fiduciary duty. The company may claim damages, by a claim which is neither contractual nor delictual, but *sui generis*.¹⁹⁸

As part of his fiduciary duty, a director has a duty of good faith.¹⁹⁹ This duty, generally speaking, entails that a director has to act, at all times, in good faith and in the interest of the company of which he is a director.²⁰⁰ If the subsidiary company comes under pressure from the holding company to transfer assets to the holding company or to provide soft loans, which would be detrimental to the financial position of the subsidiary company, and the directors of the subsidiary company acquiesce, this could constitute a breach of their fiduciary duties by the directors of the subsidiary company. Their fiduciary duties are owed to the subsidiary and not to the holding company since both are separate legal entities.²⁰¹ In *Walker v Wimborne*²⁰² the High Court of Australia said the following regarding the duties of the directors of a company:

¹⁹⁶ Para 4.4.2.2.1 above.

¹⁹⁷ The minority shareholders could bring such an action or even the liquidator if the company finds itself in liquidation.

¹⁹⁸ See *Robinson v Randfontein Estates GM Co Ltd* 1921 AD 168 199 241-242; *Symington v Pretoria-Oos Privaat Hospitaal Bedryfs (Pty) Ltd* 2005 5 SA 550 (SCA) 562; *Du Plessis NO v Phelps* 1995 4 SA 154 (C) 171; and *Volvo (SA)(Pty) Ltd v Yssel* [2008] 3 All SA 488 (W) 501.

¹⁹⁹ Blackman et al *Commentary on the Companies Act* (2002) 2 Revision service 5, 2008 8-39. See also s 76(3)(a) of the new Companies Act 71 of 2008.

²⁰⁰ Blackman et al *Commentary* 8-53, *Pergamon Press Ltd v Maxwell* [1970] 2 All ER 809 and *Charterbridge Corporation Ltd v Lloyds Bank Ltd* [1970] Ch 62.

²⁰¹ See para 1.4.1 (ii) above.

“The creditor of a company, whether it be a member of a "group" of companies in the accepted sense of that term or not, must look to that company for payment.”²⁰³

The report of the Australian Companies & Securities Advisory Committee on corporate groups²⁰⁴ refers to the case of *Parker v NRMA*²⁰⁵ where it was held that:

“The directors of each company [in a corporate group] owed separate duties to each [company]. It was not open to the directors to ignore these separate duties or to conceive of themselves as owing a higher, larger or broader duty to the group.”²⁰⁶

From the above cases it is clear that the fiduciary duties are owed to the company of which the relevant person is a director.²⁰⁷ In cases where the holding company, however, advances credit to its subsidiary the position is slightly easier, since the subsidiary is an asset of the holding company. By improving the financial stability of the subsidiary or concluding any transaction which benefits the subsidiary company, the holding company should, in theory, derive a benefit from this transaction and therefore the directors of the holding company would conceivably act in the interests of the holding company. If members of the board of the holding company are also directors of the subsidiary company, they also appear to have acted in the interest of the subsidiary company.

The more problematic cases are those where a subsidiary is forced by the holding company into upward or horizontal transactions, namely agreements with the holding company or agreements with co-subsiary companies. Where the interests of the subsidiary company are not served, the directors of the subsidiary would be breaching their fiduciary duty to act in the best interests of the subsidiary. Since the holding company or the co-subsiary companies, on a balance of probabilities, should know that

²⁰² *Walker v Wimborne* 137 CLR 1; 50 ALJR 446; 3 ACLR 529; [1976] CLC 28,534; 1976 WL 152683; 50 ALJ 591.

²⁰³ 6–7.

²⁰⁴ 38.

²⁰⁵ *Parker v NRMA* (1993) 11 ACSR 370.

²⁰⁶ 376.

²⁰⁷ See s 76(2)(a)(ii) of the new Companies Act where it is provided that a director should not knowingly cause harm to a subsidiary of the company of which he is a director.

the directors of the subsidiary company are breaching their fiduciary duty, the particular transactions could be set aside due to this breach, notwithstanding the fact that the transaction did not lead to the insolvency of the subsidiary company.²⁰⁸

Although there is a theoretical possibility of setting aside transactions of an insolvent subsidiary due to impeachable preferences in terms of the Insolvency Act²⁰⁹ or due to breaches of fiduciary duty by the directors of the company, the practical application is problematic. As with dispositions between spouses,²¹⁰ depending on the state of the companies' accounting records, it may be extremely difficult to distinguish the assets of the holding company and those of the subsidiary company.²¹¹ Creditors of an insolvent subsidiary will have to prove the impeachable dispositions without necessarily having recourse to all the facts in respect of the assets of the respective companies within the group. The agreements between companies within a group could also be numerous and complex which would complicate the evidentiary burden on a creditor.

In *Qintex Australia Finance Ltd v Schroders Australia Ltd*²¹² the court made the following observation in respect of transactions involving company groups, especially the difficulties facing creditors of a company within the group structure:

“As I see it, there is today a tension between the realities of commercial life and the applicable law in circumstances such as those in this case. In the everyday rush and bustle of commercial life in the last decade it was seldom that participants to transactions involving conglomerates with a large number of subsidiaries paused to consider which of the subsidiaries should become the contracting party.

It may be desirable for parliament to consider whether this distinction between the law and commercial practice should be maintained. This is especially the case today when the many

²⁰⁸ This claim could be based on the doctrine of notice. See *Cape Pacific Ltd v Lubner Controlling Investments (Pty) Ltd* 1995 4 SA 790 (A), para 2.7.2 above.

²⁰⁹ 24 of 1936 and see para 7.2.1 above.

²¹⁰ See s 21 of the Insolvency Act.

²¹¹ See *Qintex Australia Finance Ltd v Schroders Australia Ltd*, para 7.1 above for the facts of the case.

²¹² Para 7.1 above.

collapses of conglomerates occasion many disputes. Regularly, liquidators of subsidiaries, or of the holding company, come to court to argue as to which of their charges bears the liability.”²¹³

The Australian courts have recognised the commercial difficulties in unravelling intra-group transactions. A creditor could lack proper information when dealing with a company within a group. First of all it may be possible that he is not aware that a company forms part of a group. Secondly in cases of insolvency the liquidator will often have to incur substantial legal expenses to have certain intra-group transactions set aside, either based on breach of fiduciary duty by the directors of the subsidiary company or on the basis that those transactions constitute impeachable dispositions. As shown before this is not really a solution. Prior to a liquidator approaching a court for an order to set aside an intra-group disposition he will have to conduct a thorough investigation of the merits of the claim which prejudices creditors of the insolvent company, since they have to wait until the end of the investigation, and thereafter the litigation, before they are able to recover (part of) their claims. Even if the liquidator is successful it will be highly unlikely that a creditor will receive a substantial portion of his original claim.

A further problem for creditors is that the voiding of a transaction, where a director of a subsidiary company breached his duties to the company by entering into ill-conceived transactions with the holding company, will bring about nothing more than possible restitution and a return of the performance by the subsidiary. It was pointed out that the new South African Companies Act provides that a director should not knowingly cause harm to the company or to its subsidiary company.²¹⁴ Where this occurs the harm which may be suffered by the subsidiary will only be recoverable under this statutory remedy from the director who acted contrary to his duties and not from the holding company.²¹⁵ This remedy is therefore of limited application.

²¹³ 268–269.

²¹⁴ S 76(2)(a)(ii), para 5.3.7 above.

²¹⁵ S 77(2) and read with s 218(2).

It appears that the Harmer Report and the investigations of the Australian Companies & Securities Advisory Committee influenced the Australian legislature to some extent when it drafted the Corporations Act of 2001, especially since the legislature recognised pooling orders as well as the liability of the holding company for the debts of its insolvent subsidiary in certain circumstances.

7.5.4 The Corporations Act of 2001

The Australian legislature provides for the pooling of assets and liabilities of the companies within a group of companies.²¹⁶ Furthermore the legislature inserted a provision which would make the holding company liable for the debts of the subsidiary company in certain circumstances.²¹⁷ The provisions of the Corporations Act, however, only apply to debts incurred when the subsidiary is already insolvent²¹⁸ and do not cover the relationship between subsidiaries *inter se* or a subsidiary being liable for the debts of the holding company.²¹⁹ The provisions of the Corporations Act in respect of liability within a group therefore only apply in a very narrow set of circumstances.

The Corporations Act makes provision for circumstances under which a holding company could be held liable for insolvent trading by its subsidiary.²²⁰ Section 588V of the Corporations Act provides that:

- “(1) A corporation contravenes this section if:
- (a) the corporation is the holding company of a company at the time when the company incurs a debt; and
 - (b) the company is insolvent at that time, or becomes insolvent by incurring that debt, or by incurring at that time debts including that debt; and
 - (c) at that time, there are reasonable grounds for suspecting that the company is insolvent, or would so become insolvent, as the case may be; and
 - (d) one or both of the following subparagraphs applies:
 - (i) the corporation, or one or more of its directors, is or are aware at that time that there are such grounds for so suspecting;

²¹⁶ Ss 571-579Q which will not be discussed in the light of the fact that it essentially reflects the principles of the New Zealand provisions, para 7.3 above, in respect of pooling orders. One interesting provision is, however, s 579E(2)(c) which provides that if a pooling order is granted the effect will be that a claim which one company in a group has against another company in the group will be extinguished.

²¹⁷ S 588 V-X of the Corporations Act 2001.

²¹⁸ S 588V(1)(b).

²¹⁹ S 588V(1)(a).

²²⁰ Division 5 of the Corporations Act.

- (ii) having regard to the nature and extent of the corporation's control over the company's affairs and to any other relevant circumstances, it is reasonable to expect that:
 - (A) a holding company in the corporation's circumstances would be so aware; or
 - (B) one or more of such a holding company's directors would be so aware; and
- (e) that time is at or after the commencement of this Act.

(2) A corporation that contravenes this section is not guilty of an offence. “

From the wording of the relevant provisions²²¹ of the Corporations Act, it would appear that liability would be incurred by the holding company if the subsidiary is insolvent at the time of incurring the debt or the debt causes the insolvency and there are suspicions that the subsidiary is insolvent.²²² “Insolvent” means not being able to pay debts as and when they become due and payable.²²³ From the wording of the provision it appears that an objective test must be used to determine whether the company is insolvent.²²⁴ Whether this objective test means the reasonable holding company/director or the reasonable person in general is not entirely clear.²²⁵ A liquidator has a period of six years, from the commencement of the winding-up of the subsidiary company, to recover any debt which would be recoverable under the provisions of the Corporations Act.²²⁶

Section 588W provides that:

- “(1) Where:
- (a) a corporation has contravened section 588V in relation to the incurring of a debt by a company; and
 - (b) the person to whom the debt is owed has suffered loss or damage in relation to the debt because of the company's insolvency; and
 - (c) the debt was wholly or partly unsecured when the loss or damage was suffered; and
 - (d) the company is being wound up;
- the company's liquidator may recover from the corporation, as a debt due to the company, an amount equal to the amount of the loss or damage.
- (2) Proceedings under this section may only be begun within 6 years after the beginning of the winding up.”

²²¹ Ss 588V and W.

²²² S 588V(1)(b).

²²³ S 95A of the ACC.

²²⁴ S 588V(1)(c) refers to ‘reasonable grounds’ for suspecting that the company is insolvent.

²²⁵ Austin and Ramsay are of the opinion that one has to look at the reasonable person. See Austin & Ramsay *Fords’ Principles of Corporations Law* 1001.

²²⁶ S 588W(2).

The Corporations Act provides defences to the holding company should there be any action by the liquidator against them.²²⁷ The holding company (and each of its directors) could aver that they had reasonable grounds to expect, and in fact did expect, that the company was solvent at the time that the debt was incurred and that the company would remain solvent even if it incurred the debt and any other debts which it incurred at that time.²²⁸

It is also a defence if the holding company and its directors (if any) can prove that at the time that the debt was incurred, they reasonably expected that a competent and reliable person would provide adequate information about the solvency of the company and that the person was fulfilling that responsibility. They therefore expected that the company was solvent based on the information of that competent and reliable person and that the company would remain solvent even if it incurred the debt and any other debts at that time.²²⁹

A further defence for a director would be to show that he was not part of the management of the holding company when the subsidiary incurred the debt due to illness or another good reason.²³⁰ The last available defence is for the holding company to show that it took all reasonable steps to prevent the subsidiary company from incurring the debt.²³¹

The Corporations Act makes specific provision for directors of wholly-owned subsidiary companies.²³² The Corporations Act provides that:

“A director of a corporation that is a wholly-owned subsidiary of a body corporate is taken to act in good faith in the best interests of the subsidiary if:

- (a) the constitution of the subsidiary expressly authorises the director to act in the best interests of the holding company; and
- (b) the director acts in good faith in the best interests of the holding company; and

²²⁷ S 588X.

²²⁸ S 588X(2).

²²⁹ S 588X(3).

²³⁰ S 588X(4).

²³¹ S 588X(5).

²³² S 187 and is based on section 131(2) of the New Zealand Companies Act 1993.

(c) the subsidiary is not insolvent at the time the director acts and does not become insolvent because of the director's act.”²³³

The provisions of the ACC in respect of the liability of the holding company for the debts of the subsidiary company are only applicable in a very narrow set of circumstances. The provisions seem very similar to the argument that a holding company could incur liability under section 424 of the 1973 Companies Act of South Africa. The Australian legislature makes it fairly simple for a creditor to hold the holding company liable but simultaneously restricts the applicability of the liability provisions. The discussion of the provisions of the Corporations Act has been brief due to the fact that the legislation is relatively new and significant cases could not be found. The suitability of the provisions of the Corporations Act will be discussed in some detail at the end of this chapter.

7.6 Dutch Law

This section will examine a few Dutch cases which, *prima facie*, appear to impose delictual liability on the holding company of an insolvent Dutch subsidiary under certain circumstances. In the *Osby*²³⁴ case Osby Sweden incorporated a wholly-owned subsidiary, Osby Netherlands. The business of the Dutch subsidiary was not successful and soon after its incorporation it was already experiencing financial difficulties. The holding company provided credit to the subsidiary which in return transferred all of its assets, movable and immovable and including future assets, to the holding company as security. The other creditors of the subsidiary were not aware of the precarious financial position of the subsidiary, nor did they know about the transfer of all the assets as security to the holding company. Debts were always duly paid by the subsidiary which to the outside world created the impression of a financially stable and expanding company. In the end though the subsidiary company went into liquidation, prior to which most of its moveable assets were removed and taken to a fellow subsidiary in Germany.

One of the concurrent creditors of Osby Netherlands brought an action to recover its losses from the holding company. In the court evidence was presented that the financial

²³³ S 187.

²³⁴ Decided in the *Osby Hoge Raad* on 25 September 1981, *NJ* 1982/443.

position of Osby steadily deteriorated over the five years of its existence. The financial position deteriorated to such an extent that the major creditor bank, Algemene Bank Nederland, terminated its relationship with Osby in 1967. The Bank of America became the banker of the company but demanded that the holding company stood surety. The financial position became worse, however. From the facts it was also clear that the holding company was directly involved in the management of the subsidiary company and determined the policies of the company. There was also an extensive mixing of assets of the holding company and the subsidiary company.

The court held that the holding company did not take the necessary care in the management of the subsidiary and that it held a terminally ill company artificially alive to the detriment of creditors when circumstances demanded that other actions should have been taken. Also the holding company ensured that through the transfer of assets and preferent claims which it obtained, it stood in a much more advantageous position than other creditors. The court then stated that if a holding company owns all the shares in a subsidiary company and provides credit to the subsidiary and thereafter transfers all the assets of the subsidiary, present and future, completely or nearly completely to the holding company as security which results in new creditors of the subsidiary practically no longer having any recourse against the subsidiary, there can be an unlawful act towards these creditors in circumstances where the holding company neglected to consider the interests of the new creditors. This will especially be the case if the holding company has such insight in and control over the policies of the subsidiary that it, in the light of the extent of its claim against the subsidiary, the transfer of the assets of the subsidiary as security and the nature of the business, knows or should have foreseen that new creditors would be prejudiced. The holding company therefore has to take care that creditors are protected.²³⁵

²³⁵ 1526. “Indien een moedermaatschappij alle aandelen in een dochtermaatschappij bezit en aan de dochter krediet heeft verstrekt en vervolgens de active van de dochter, toekomstige inbegrepen, volledig of nagenoeg volledig van deze in zekerheidseigendom verwerft. Aldus dat de dochter aan nieuwe schuldeisers die haar na de zekerheidsoverdracht krediet geven praktisch geen verhaal meer bidet, kan er, indien de moedermaatschappij nalaat zich de belangen van de nieuwe schuldeisers aan te trekken, onder omstandigheden sprake zijn van een onrechtmatige daad van haar jegens dezen. Met name zal dit zo zijn, indien de moeder een zodanig inzicht in en zeggenschap over het beleid van de dochter heeft, dat zij, gelet op de omvang van haar vordering en van de zekerheidsoverdracht en het verloop van zaken in het bedrijf van de dochter, ten tijde van gedragingen als voormeld

In the *Nimox / Auditrade* case,²³⁶ Nimox was the holding company of the wholly owned Auditrade. In 1983 Auditrade declared a dividend from its reserves which drastically reduced its liquidity. Instead of paying the dividend in cash, the dividend was converted into a loan to Nimox which ceded its rights against Auditrade to Heller. During 1984 Auditrade applied for a postponement or rescheduling of its debt repayments but soon found itself in liquidation.

The court held that the resolution which passed the dividend and converted it into a loan was unlawful since it elevated the holding company's position from being a shareholder to that of a creditor. The holding company, even when voting as (the only) shareholder of Auditrade should have known that the payment of the dividend would severely prejudice the position of the other creditors. The loss to the remaining creditors of Auditrade should therefore have been foreseen by the holding company.

In the *Albada Jelgersma*²³⁷ case, Albada took up all the shares in Wijnalda Kuntz BV at some time during 1980. Inza was a creditor of Albada. Inza supplied milk products to Albada over a period of five months between September 1980 and February 1981 but received no payment. Albada issued a letter to suppliers, except Inza, in September 1980 in which it notified suppliers of Wijnalda that it has taken Wijnalda over and that the liabilities of Wijnalda would be taken care of. The claim of Inza, however, was not satisfied and it claimed the outstanding amounts from Albada.

The Hoge Raad held Albada liable for the losses of Inza because of the wrongful actions of Albada. The wrongfulness of Albada's actions was partly due to the fact that Albada extensively broadcast its takeover of Wijnalda but even more due to Albada's extensive involvement in the management and policies of Wijnalda. Albada therefore had to take measures to ensure that the creditors of Wijnalda would not be prejudiced. These measures could have included not buying any new supplies from suppliers or the

wist of behoorde te voorzien dat nieuwe schuldeisers zouden worden benadeeld bij gebrek aan verhaal, en desalniettemin nalaat zorg te dragen dat die schuldeisers worden voldaan.”

²³⁶ *Nimox / Auditrade* Hoge Raad 8 November 1991 *NJ* 1992/174.

²³⁷ *Albada Jelgersma* Hoge Raad 19 February 1988 *NJ* 1988/487.

payment by Albada of the debts of Wijnalda. Having regard to the *Osby* case, it is submitted that Albada, as the holding company, would also have been sufficiently informed about the state of the subsidiary's liquidity.²³⁸

In the *Coral*²³⁹ case the facts were as follows. Forsythe was the wholly-owned subsidiary of Stalt. At some stage Coral and Forsythe entered into a charter party in terms of which Forsythe would transport oil from the United States of America to the United Kingdom. Forsythe failed to comply with its duties. Coral and Forsythe entered into a subsequent agreement in terms of which Forsythe would pay the charter fee, demurrage and cancellation fees. Forsythe paid the charter fee but failed to perform in respect of the cancellation fee or demurrage. The dispute in respect of the payment of the demurrage and cancellation fee was referred to arbitration where an award was made against Forsythe. Forsythe still failed to make payment in terms of the arbitration award. Forsythe, prior to the agreement with Coral for the payment of the demurrage, cancellation fees and charter fees, decided to terminate all its activities and sold all the shares it held in Forsythe International Cyprus Ltd, namely 100%, to Stalt. This effectively meant that Coral had no effective recourse against Forsythe. The sale of the shares by Forsythe to Stalt effectively frustrated the claim of Coral against Forsythe.

Coral alleged that Stalt acted wrongfully in a number of ways. The wrongful actions were in respect of actions of Forsyth which were at the behest of Stalt. The sale of the Forsythe International Cyprus Ltd shares severely prejudiced the possibilities of attaching property of Forsythe to comply with the later arbitration award. If the sale of these shares was in good faith it should have been at their true value and not at the value the shares were sold for. Coral further alleged that the proceeds of the assets of Forsythe, when it terminated its activities, should have been maintained to satisfy any award which could, or would, have been obtained by Coral in the arbitration proceedings against Forsythe. The proceeds of the Cyprus shares in particular were misappropriated.

²³⁸ Olaerts *Vennootschappelijke beleidsbepaling* 208.

²³⁹ *Coral* Hoge Raad 12 June 1998 *NJ* 1998/727.

From the facts of the case it was clear that Stalt was directly and actively involved in the management and affairs of Forsythe. The court held that the holding company and the subsidiary would have had access to the same information in respect of the financial position of Forsythe after the sale of the Forsythe Cyprus shares. The two companies should have been aware and should therefore have foreseen that the claim of Coral would or could remain unsatisfied if the other creditors were being paid. The wrongfulness was therefore situated in this fact: the holding company and subsidiary company possessed the same knowledge and facts and from this could be deemed to have been one entity.²⁴⁰

The last Dutch case to be discussed is *Hurks / Hurks Bouwbedrijf Amsterdam BV* (HBA).²⁴¹ HBA was the wholly-owned subsidiary company of Bouwgroep Hurks BV. Mr Hurks was the only shareholder of Bouwgroep and initially also the sole director. Bouwgroep was responsible for the financial aspects of the business of HBA. HBA was also bound for the debts of co-subsidiaries and the holding company in terms of an agreement with a bank. HBA found itself in a precarious financial position but still encumbered some of its assets in favour of a bank and transferred funds to Bouwgroep. The creditors of HBA alleged that Hurks and Bouwgroep acted wrongfully from the date on which HBA found itself in a precarious financial position. It was submitted by the creditors that the holding company and Hurks should have taken positive steps *vis-à-vis* the creditors of HBA, by HBA not incurring new debts and warning the creditors of HBA of the precarious financial position of HBA.

The Hoge Raad focused on the internal structure of the two companies and that HBA was relatively free to conduct its own business. The Hoge Raad recognised that the holding company did not have the legal power, in terms of the articles of association of the subsidiary company, to give binding instructions in respect of the management or conduct of the business of HBA. The court then, startlingly, stated that the lack of legal power did not mean that the holding company, as sole shareholder of HBA, did not have the *de facto* power to give instructions to the subsidiary company which it had to follow

²⁴⁰ Olaerts *Vennootschappelijke beleidsbepaling* 210.

²⁴¹ *Hurks / Hurks Bouwbedrijf Amsterdam BV* Hoge Raad 21 December 2001 *NJ* 2005/96.

and implement. A legal duty therefore rested on the holding company to warn the creditors of the subsidiary of the precarious financial position of the subsidiary company. This decision rests purely on the factual power which the holding company had.

It would appear that, in all the above mentioned Dutch cases, the interference of the holding company in the affairs of the subsidiary weighed heavily on the minds of the judges of the Hoge Raad in holding the respective holding companies liable. The exception was the *Bouwgroep/HBA* case where a positive duty to act was implied even where the holding company did not interfere in the management of the subsidiary company. The other cases discussed above dealt with the ostensible creditworthiness of a subsidiary which caused a creditor to enter into agreements with the subsidiary or the withdrawal of capital by means of dividends which could be prejudicial to the long or medium-term stability of the subsidiary.

Olaerts argues that the distinction between lawful and wrongful withdrawal of funds by the holding company is a very thin and tenuous one.²⁴² Due to the nature of the relationship between the holding company and the subsidiary the holding company is ultimately an investor in the subsidiary company and entitled to have dividends paid out if, and when, there is compliance with the necessary rules and regulations.

The other cases mainly dealt with circumstances where the holding company was actively involved in the management of the subsidiary or also a creditor. In this situation the courts either held that the holding company should probably have subordinated its claims against the subsidiary to those of the other creditors, or that there was a duty to warn the creditors of the subsidiary of its financial position.

When one evaluates the Dutch cases it is doubtful whether they can be applied directly in South Africa. The main reason for this is that it is not entirely clear what the basis of the liability is. *Prima facie* the Dutch term “onrechtmatige daad” could imply that one is dealing with a delictual claim. However, when one delves beneath the surface it does not

²⁴² Olaerts *Vennootschappelijke beleidsbepaling* 226.

appear that these cases were decided on a delictual basis but more on a hybrid of what, in terms of our law, would be the piercing of the corporate veil doctrine and the law of delict. That does, however, not imply that the South African legal system could then summarily dismiss the possibility of a delictual claim against the holding company in justifiable circumstances where the actions of the holding company were wrongful *vis-à-vis* a creditor of the subsidiary company, particularly in a situation where the subsidiary is in a precarious financial position. As discussed above, however, the problematic evidentiary aspects would be the question of wrongfulness and the need to establish a duty of care on the holding company *vis-à-vis* the creditors of its subsidiary company.²⁴³

7.7 Letters of comfort

The effect of a letter of comfort by a holding company which induces a party to enter into an agreement with the former's subsidiary could be especially relevant, not only in the context of a contractual claim but also in the context of the law of delict. *Prima facie* one would assume that a letter of comfort creates an impression of creditworthiness of the subsidiary and that the holding company gives comfort to a potential creditor of a subsidiary that the subsidiary will be able to perform. The English courts and the courts of certain other common-law jurisdictions have, however, adopted a different approach to letters of comfort. Typically a letter of comfort is issued by a holding company in which it confirms that it is "its policy that its subsidiaries are at all times able to meet their liabilities [...] but is usually designed to provide no more than moral re-assurance."²⁴⁴ According to Goode a letter of comfort will typically be issued where the holding company refuses to provide a guarantee or stand surety for the liabilities of the subsidiary company.²⁴⁵

In *Kleinwort Benson Ltd v Malaysia Mining Corporation Berhad*²⁴⁶ Malaysia Mining incorporated a wholly owned subsidiary, MMC Metals Ltd, with a start up capital of £1,5 million, which was insufficient to trade on the London Metal Exchange. MMC Metals

²⁴³ See para 7.2.3 above.

²⁴⁴ Goode *Commercial Law* 3ed (2004) 802.

²⁴⁵ Goode *Commercial Law* 820.

²⁴⁶ *Kleinwort Benson Ltd v Malaysia Mining Corporation Berhad* [1989] 1 W.L.R. 379 Court of Appeal.

sought to obtain funds from Kleinwort Benson, a merchant bank. Kleinwort Benson needed some form of assurance from Malaysia Mining, the holding company of MMC Metals, that MMC Metals would repay the loan amount. Malaysia Mining issued a letter of comfort as part of an acceptance of a credit/multi-currency cash loan facility which Kleinwort Benson granted to MMC Metals to a maximum of £5 million. The letter of comfort included the statement that it was the policy of Malaysia Mining to ensure that the business of MMC Metals was at all times in a position to meet its obligations to Kleinwort Benson in terms of the cash loan facility. The cash loan facility was later increased to a maximum of £10 million in reliance upon a second letter of comfort from Malaysia Mining which was couched in substantially identical terms to the first letter of comfort. MMC Metals defaulted on its obligations, was liquidated and Malaysia Mining refused to perform the outstanding obligations of MMC Metals towards Kleinwort Benson. Kleinwort Benson subsequently sought to obtain judgment for damages against Malaysia Mining and based its claim on the statement in the letter of comfort referred to above. The court *a quo*²⁴⁷ granted judgment in favour of Kleinwort Benson.

The thrust of the appeal of Malaysia Mining was that it did not enter into any contractual obligations to Kleinwort Benson. The court of first instance considered a number of authorities²⁴⁸ and accepted the following principles:

- “(i) An agreement, even though it is supported by consideration, is not binding as a contract if it was made without any intention of creating legal relations.
- (ii) In the case of an ordinary commercial transaction it is normally not necessary to prove that the parties in fact intended to create legal relations: the onus of proving that there was no such intention ‘is on the party who asserts that no legal effect was intended, and the onus is a heavy one:’ *per* Megaw J in *Edwards v Skyways Ltd* [1964] 1 W.L.R 349, 355.
- (iii) To decide whether legal effect was intended, the courts normally apply an objective test; for example, where the sale of a house is *not* ‘subject to contract,’ either party is likely to be bound even though he subjectively believed that he would not be bound until the usual exchange of contracts had taken place.

²⁴⁷ [1988] 1 W.L.R. 799.

²⁴⁸ *Rose and Frank Co v JR Crompton and Brothers Ltd* [1923] 2 K.B 261; *Edwards v Skyways Ltd* [1964] 1 All ER 494; *Prenn v Simmonds* [1971] 1 W.L.R 1381; *Chemco Leasing v S. p. A. v Rediffusion Plc* (unreported), 19 July 1985 and 11 December 1986; Court of Appeal (Civil Division), Transcript No. 1115 of 1986 and *Chitty on Contracts* 25ed (1983), para 123.

- (iii) The court will, in deciding that question, attach weight (a) to the importance of the agreement of the parties, and (b) to the fact that one of them has acted in reliance upon it.
- (iv) In the search for agreed terms of a commercial transaction, businessmen may adopt language of deliberate equivocation in the hope that all will go well. It may, therefore, be artificial to try to ascertain the common intention of the parties as to the legal effect of such a claim if in fact their common intention was that the claim should have such effect as a judge or arbitrator should decide: see Staughton J in *Chemco Leasing S.p.A v Rediffusion Plc*, on 19 July 1985, cited by Hirst J [1988] 1 W.L.R 799, 806G. Nevertheless, the court's task is to ascertain what common intentions should be ascribed to the parties from the terms of the documents and the surrounding circumstances.”²⁴⁹

The court of first instance followed the principles as set out above and came to the conclusion that Malaysia Mining could not prove that the parties did not intend that the relevant paragraph in the letter of comfort would have effect as a contractual term. The judge in the court of first instance held that it was clear that there was an undertaking on the side of Malaysia Mining that it was its policy to ensure that MMC Metals was in a position to meet its liabilities towards Kleinwort Benson in terms of the cash loan facility.

The Court of Appeal held that Malaysian Mining made a statement as to what their policy was, and did not in the relevant paragraph of the two letters of comfort expressly promise that the policy, in respect of ensuring that its subsidiary would comply with its obligations, would be continued in future. The Court of Appeal held that the words in question were a statement in respect of the present fact and not a promise of future conduct. Furthermore the Court of Appeal held that the concept of a letter of comfort was known to the parties in their negotiations, especially after Malaysia Mining refused to assume joint and several liability and also refused to give a guarantee for the obligations of MMC Metals. The intention was therefore clearly that Malaysia Mining would give moral comfort for the obligations of its subsidiary and not undertake any legal liability for those obligations towards Kleinwort Benson. Since the preceding paragraph expressly mentioned that Malaysia Mining would not reduce its financial interest in Metals without the consent of Kleinwort Benson, the Court of Appeal held that this constituted a legally binding undertaking by the holding company. The holding company admitted, in any

²⁴⁹ Court of Appeal 383-384.

event, that the preceding paragraph to the paragraph in question was meant to be a legally binding undertaking. The Court of Appeal held that the paragraphs preceding the offending paragraph would have been superfluous if the intention of the parties was to create a legally binding undertaking in the offending paragraph.

The factual circumstances under which the letters of comfort were given were also very relevant. The holding company refused to be bound jointly and severally as co-principal debtor and declined to issue a guarantee that the subsidiary would comply with its obligations. The intention was merely to confirm that the policy of the holding company was to ensure that the obligations would be met but nothing prevented from changing that policy if circumstances changed in the future.

In *Bouygues SA & Another v Shanghai Links Executive Community Ltd*²⁵⁰ the Hong Kong court confirmed the principles as set out by the Court of Appeal in the *Kleinwort Benson* case. It held that the test was whether the written statements by a party amounted to simple statements of fact or whether they were contractual promises of future conduct. The court further held that:

“The letter of comfort was a tool of commerce developed to provide an alternative to a guarantee or surety. The writer was normally a parent company unwilling to give security for its subsidiary's liabilities. Thus, letters of comfort were issued when the parent company did not want to incur legal liability, it wished to protect its own credit rating or it wanted to avoid showing a contingent liability on its balance sheet.”²⁵¹

The court held further that:

“The question was whether the letters contained simply statements of fact regarding the parent company's current policy or whether they amounted to contractual promises as to the parent company's future conduct. If the former, the letter is a letter of comfort with no legal effect. If the latter, the promise it contains is enforceable (provided that the other elements of enforceability are satisfied, such as consideration). If the letter contains express words of promise, no difficulty arises [...] since the issue is ultimately one of construction, the absence of express words of

²⁵⁰ *Bouygues SA v Shanghai Links Executive Community Ltd* [1998] 2 HKLRD 479.

²⁵¹ 490I-J.

promise means that it is necessary to consider carefully the context in which the letters were written.”²⁵²

So-called letters of awareness can, in principle, be described with regards to their legal effect in similar terms to a letter of comfort. This boils down to a notice from the issuer that it is aware of the fact that a lender of money has made an offer to make a loan facility available to a prospective borrower.²⁵³ In *Hong Kong and Shanghai Banking Corporation Ltd v Jurong Engineering Ltd*²⁵⁴ the Singapore High Court had to decide on the legally binding status of a letter of awareness. The plaintiff instituted an action for damages in the amount of approximately \$9 million against the defendants. Huger Corporation Pte (Ltd) was an associate company of the first defendant for a period of time, then became a subsidiary company of the first defendant for a period of two years and then became an associate company again. When Huger was wound up it owed money to the plaintiff in terms of the credit facilities which the plaintiff had granted to it.

The facts *in casu* were fairly similar to the letters of comfort cases discussed above. The plaintiff wanted to lend money to Huger. The first defendant refused to give a guarantee as security for any loans to Huger but instead was willing to give a letter of awareness. The plaintiff drafted the letter. In one of the paragraphs of the draft letter the word “undertake” was replaced with the word “ensure” by the first defendant, to which the plaintiff did not object. Two further letters of awareness were issued by the first defendant in substantially similar terms as the first one. In the next two, however, the word “undertake” was not replaced by the word “ensure”. Huger started encountering financial difficulties and was eventually wound up. The plaintiff based their claim against the first defendant on the breach of the third letter of awareness.

²⁵² 491B-E.

²⁵³ Goode *Commercial Law* 802.

²⁵⁴ *Hong Kong and Shanghai Banking Corporation Ltd v Jurong Engineering Ltd and Ors* [2000] 2 SLR 54.

The court *in casu* dismissed the plaintiff's claim, since no legal obligations were undertaken by the first defendant.²⁵⁵ The court held that it must look at the substance of the agreement and not just at the terminology used by the parties.²⁵⁶ The court must, furthermore, look at the surrounding circumstances and the text of the letter of awareness to determine the intentions of the respective parties to the agreement.²⁵⁷

The question that needs to be addressed is whether the courts are correct in respect of their approach to letters of comfort and letters of awareness. These letters, as the two cases discussed above show, are substantially standard-form documents which seem to serve no purpose, whatsoever.²⁵⁸ Ultimately they will always lead to disagreement; the recipient of the letters or the lender, inevitably, will always allege that it was its intention that the letter of comfort or awareness was meant to be a legally binding document when the borrower defaults on its obligations. The grantor of the letters, usually the holding company of the borrower, will always deny that it was its intention to incur any legal obligations *vis-à-vis* the lender. Since the wording is in general very similar, if not the same, in most letters of comfort the question arises why the lender would proceed with the loans if it is, or should be, aware of the fact that the letters serve no practical function. Are they merely naïve in believing that the holding company or grantor of the letter of comfort/awareness will either as a matter of good faith, or to rescue its investment in the subsidiary borrower, perform the obligations which the subsidiary is not capable of, or do the lenders genuinely believe that there may exist some form of legal recourse against the holding company?

Given the fact that these letters are mainly issued by holding companies in respect of loans of their subsidiaries from banks, one would expect a level of sophistication on the side of both borrower and lender with the concomitant access to legal advice. Also, the

²⁵⁵ 77.

²⁵⁶ 71.

²⁵⁷ 71.

²⁵⁸ Compare, however, *Edwards v Skyways Ltd* [1964] 1 All ER 494 where the court held that there is a presumption that the parties to a letter of comfort or awareness intended to create binding legal obligations in the absence of an intention to the contrary.

lender bank would, or should in most cases, be in a stronger bargaining position than the lender. If this is so, why would banks be satisfied with a legally non-binding letter of comfort when they have the bargaining power to insist on security from the holding company? Could it conceivably not be possible that the banks or any recipient of a letter of comfort or awareness believes that this is some form of security? Even if this is so, the courts have held that they will look objectively at whether there was an intention to create legally binding agreements or not; i.e. the officious bystander test. But if this is the case, and if most, or all, letters of comfort are similarly worded, a letter of comfort will virtually never be interpreted as having been intended to create legally enforceable obligations between the parties to the letter of comfort. When banks deal with large multi-national companies it could be argued that the borrower has more negotiating power, due to its size, to take its business somewhere else, which forces banks to extend loans without obtaining any proper security and having to settle for a letter of comfort.

If these letters of comfort or awareness do not constitute legally enforceable obligations between the lender and the holding company, could they in any manner be used in a delictual action for pure economic loss which the lender has suffered? The elements of a delict will have to be proved for the claim to be successful. There clearly was an act in the form of an issue of a letter of awareness or comfort, there was causation in that the lender will allege that the letter caused him to enter into a legally binding agreement with the subsidiary company but which transpired to be a worthless piece of paper which caused him loss since he is unable to recover his losses contractually and there are clearly damages. It is submitted that the two difficult elements will be fault and wrongfulness.²⁵⁹ Fault was arguably present on the side of the holding company through negligently creating the impression that it would stand in for the obligations of the subsidiary company to the lender of the funds in terms of a loan agreement. The problematic aspect, as with pure economic loss,²⁶⁰ is the question of wrongfulness. To answer this, again it must be asked whether the holding company owed a duty of care to the lender of money to its subsidiary.

²⁵⁹ See para 7.2.3 above.

²⁶⁰ Above.

Since there is no legally binding contract between the parties to the letters of comfort in respect of the payment of the loan by the holding company, a duty of care could more easily be implied, especially where the holding company is intimately involved in the management and policies of the subsidiary company.²⁶¹ The holding company is privy to the financial position of the subsidiary and should be aware at a very early stage that the subsidiary company is in financial difficulties. The Dutch cases, which were referred to earlier,²⁶² could provide useful guidance here. An ongoing duty to disclose the financial position of the subsidiary company could be placed on the holding company, not only due to the fact that it has financial information in respect of the subsidiary which is not readily available, but also because some form of close, but non-contractual, relationship exists between the lender and the holding company. This is not just a tenuous link which exists between the parties but a strong one which probably had been nurtured over time by means of protracted negotiations. The usual reluctance of the courts to imply a duty of care due to the possible proliferation of actions against the holding company would also not be of relevance here since the relationship is strictly between the lender and the holding company and is not concerned with liability to an indeterminable number of faceless potential claimants.

When one considers the South African cases which dealt with pure economic loss and then specifically the *Holtzhausen*²⁶³ case, the previously quoted passage²⁶⁴ would appear to be apt in the context of letters of comfort and letters of awareness. Since there is no

²⁶¹ See *Lillicrap, Wassenaar and Partners v Pilkington Brothers (SA) (Pty) Ltd* 1985 1 SA 475 (A) but compare the decision of the Supreme Court of Appeal in *Holtzhausen v ABSA Bank Ltd* 2008 5 SA 630 (SCA), para 7.2.3 above, where the Court puts the *Lillicrap* decision in perspective within the context of a delictual claim where there is a contract between the parties.

²⁶² Para 7.9 above.

²⁶³ Above.

²⁶⁴ 635 E-I of the *Holtzhausen* decision: "So far as unlawfulness is concerned, the following findings might be made on the evidence led thus far: That the statement by the bank manager was made in response to a serious request; that the plaintiff approached the bank manager because of his expertise and knowledge of banking matters; and that the plaintiff's purpose in making the enquiry was, to the knowledge of the bank manager, to ascertain whether he could safely proceed with the transaction. It could be inferred that the bank manager realised that the plaintiff would rely on his answer." Although this statement is the converse of the letter of comfort situation, namely in the *Holtzhausen* case it was the lender who created the duty of care, whereas in the letter of comfort it is the borrower, the two situations are certainly analogous.

contract between the holding company and the bank or recipient of the letter of awareness or letter of comfort, the problematic aspect of a delictual claim based on contract which the South African courts have been battling with should not then enter the discussion.²⁶⁵ If the status of a letter of comfort and letter of awareness imposes merely moral obligations it still cannot be denied that some form of unique relationship comes into existence between the holding company and the recipient or holder of the letter of comfort or awareness. It is questionable whether this relationship is purely moral in its nature. It is submitted that the relationship between the holding company and the recipient or holder of the letter of awareness or comfort is at best a *quasi* contractual one or at least a *sui generis* one. It is further submitted, irrespective of the name of the relationship between the respective parties, that due to this relationship, which has come into existence between the holding company and the recipient of the relevant letter of comfort or awareness, a duty of care has arisen towards the recipient of that letter.

What would the content of this duty be, or put differently, what would constitute wrongful behaviour which would lead to the duty of care being breached? Should the wrongful act be the failure of the holding company to pay the debts of the subsidiary which then causes the holder of the letter of comfort or awareness loss, or should it be restricted to a situation where there was a duty on the holding company to inform the recipient of the letter of comfort or awareness of the precarious position of the subsidiary to enable that party to mitigate its losses by, for example, halting the provision of credit to the subsidiary? It is submitted that, at the very least, there rests a positive duty on the holding company, under these circumstances, to inform the holder of the letter of comfort or awareness of the financial position of the subsidiary. From the moment that the holding company realises that there is a risk that the subsidiary company may not be capable of performing its obligations and unless and until this danger is removed the holding company moves from being negligent to being possibly reckless.

²⁶⁵ See para 7.2.3 above.

In *Philotex (Pty) Ltd v Snyman*²⁶⁶ the court held that if the directors are of the opinion that there is a risk that a company may not repay its debts and it incurs new debts, they could be found to have acted negligently. The position would be no different here where the holding company is aware that the subsidiary company is in financial trouble and that there is a (real) risk that it will not be capable of repaying any existing debt, let alone new debt. The silence of the holding company, namely not informing the holder of the letter of the impending financial difficulties of the subsidiary could be considered to be negligent.

The courts²⁶⁷ have held that the moral obligation that the holding company undertakes is in respect of its current policy in respect of the solvency of the subsidiary and that it ensures that the subsidiary will perform its obligations. But what is this “current policy”? Is it the policy for one financial year, or for two, or just until the subsidiary becomes a business liability? If the policy is only for one year, should there then not be a duty on the holding company to inform the holder of the letter of comfort or awareness that the policy of the company *vis-à-vis* its subsidiary has changed? Surely the holder of the letter of comfort will be under the (mistaken) belief that until it is notified to the contrary, the policy of the holding company is still as set out in the letter of comfort. Any debts therefore incurred after a change of policy or after the moment the holding company realises the risk of non-payment of debts, should be considered to be incurred through its negligence.

It should then be asked whether it would be against public policy to impose or imply a duty of care on the holding company towards the holder of the letter of comfort or awareness. There can be no convincing public policy argument against delictual liability. First of all there is not an indeterminate class of potential plaintiffs who may attempt to hold the holding company liable. The only plaintiff it had a duty of care towards was the holder of the letter of comfort or awareness. Furthermore, the duty of care is based on, or founded by, the existing relationship between the parties where the holder of the letter of

²⁶⁶ *Philotex (Pty) Ltd v Snyman* 1998 2 SA 138 (A).

²⁶⁷ See the *Kleinwort Benson* case above.

comfort relies strongly on the good faith of the holding company in the absence of securities for the debts of the subsidiary. The holding company is, or should reasonably be, aware of this reliance. The duty of care does therefore not arise casually but because of the prior or existing relationship between the holding company and the holder of the letter of comfort or awareness. The content of the duty is also not onerous on the holding company. It merely has to inform the holder of the letter of comfort or awareness that its policy towards the subsidiary has changed or that the subsidiary company is finding itself in financial difficulties. The holder of the letter of comfort or awareness can then take steps to either prevent, or at least mitigate, its losses. This position would tie in perfectly with the Dutch principles discussed earlier.²⁶⁸

It was shown earlier that holding companies in Dutch law could be held liable for the debts of the subsidiary based on the wrongful actions of the holding companies. It was shown, however, that the liability does not appear to be strictly delictual but more of a disguised piercing of the corporate veil. However, some useful pointers have come out of the discussed cases.²⁶⁹ The most important one is where the holding company is actively involved in the management and policies of the subsidiary company without necessarily having the same directors of its own board on the board of the subsidiary company. In these cases the holding company is aware, or at the very least should be aware, of the damages which a creditor bank will incur should the subsidiary company incur any further debts where the financial position of the subsidiary is precarious. A reasonable person would under these circumstances foresee that a creditor may suffer loss and would refrain from incurring further liabilities. Under these circumstances there should be no policy considerations to impede a successful action by a creditor bank against a holding company which has issued a letter of comfort or awareness and has not subsequently warned the bank that it has changed its policy towards the subsidiary company or that the subsidiary company is hovering precariously on the precipice of bankruptcy. A strong argument could be made out that the directors of the subsidiary company, the holding

²⁶⁸ See para 7.6 above.

²⁶⁹ See para 7.6 above.

company itself and the directors of the holding company should under these specific facts be held jointly and severally liable for the loss of the creditor bank.

7.8 Alternative basis for liability of the holding company

In chapters one and six reference was made to abuses which Muscat identified within groups of companies and which according to him justified changes to the law to address these problems or abuses.²⁷⁰ His recommendations will be discussed below and evaluated for their potential application in South Africa.

7.8.1 The subservient company

The subservient subsidiary company could equally well be called the submissive company. This is used to describe the situation where the subsidiary company has no independent will of its own but merely exists to serve its holding company or other companies within the group. According to Muscat the external creditors of a subservient company can be harmed in a number of ways. These include business opportunities which the holding company forces the subsidiary to waive in favour of another group member, internal asset transfers to the detriment of the subsidiary,²⁷¹ the forced declaration of dividends by the subservient company to divert the profits to the holding company instead of re-investing them in the subsidiary company, the holding company forcing the subsidiary to extend loans to other group members and the commingling of assets.²⁷² The effect on creditors is threefold. Firstly, the net asset value and profitability of the subsidiary is diminished which weakens the subsidiary financially. The diversion of corporate opportunities reduces the likelihood of the subsidiary expanding its business and becoming self-sufficient, which exposes it to potential insolvency in the medium to long term. Secondly, the treatment by the holding company of the subsidiary in these circumstances constitutes an abuse of the privilege of incorporation²⁷³ by the holding company and makes a mockery of the supposed separate juristic personality of the two

²⁷⁰ See paras 1.7 and 6.5 above.

²⁷¹ So-called transfer pricing.

²⁷² Muscat *Liability of the Holding Company* 201.

²⁷³ Compare ss 7(a) and 13(1) of the new Companies Act regarding the right to incorporate a company.

entities. Thirdly, for the holding company to deprive the subsidiary of the means to survive and then abandon it when it becomes insolvent is “repugnant to one’s sense of justice and fair play”.²⁷⁴ A further problem of the concept of the subservient company is that the waiver of business opportunities and declarations of dividends are not *per se* unjustified and abusive. The problem with the law as it stands is that it looks at specific behaviour by the holding company instead of at the global picture of how the holding company treats the subsidiary.

Muscat is of the opinion that the available remedies in English law are not sufficient to alleviate the problem, since these all focus on individual circumstances of abuse instead of on the holistic picture.²⁷⁵ He proposes that the holding company should be held liable “for the debts of its insolvent subservient subsidiaries to such an extent as may be determined by the court”.²⁷⁶ Subservience is then defined in vague terms as “intrusive domination”, “act[ing] to its own detriment and in the interests of the holding company or some other unit within the corporate group” at the behest of the holding company.²⁷⁷ The subservience, however, also has to be continuous to attract liability for the holding company, a court should look at the global picture of how the holding company treats the subsidiary and not focus on individual transactions, and the holding company should only be held liable in cases of insolvency. The liability which is imposed should be by way of a contributory order and should vest in the liquidator and should not be an independent cause of action for the creditors of the subsidiary company. The remedy should be available to voluntary and involuntary creditors and should supplement existing remedies.²⁷⁸

²⁷⁴ Muscat *Liability of the Holding Company* 201.

²⁷⁵ See Muscat *Liability of the Holding Company* 201 – 299.

²⁷⁶ Muscat *Liability of the Holding Company* 299. See also para 7.3 above regarding the provisions of the New Zealand Companies Act which grants the court the power to order the pooling of assets or the making of contributions if it is just and equitable and the provision of guidelines to assist the court.

²⁷⁷ Muscat *Liability of the Holding Company* 300.

²⁷⁸ Muscat *Liability of the Holding Company* 301 – 305.

7.8.2 The undercapitalised subsidiary company

The next form of abuse by the holding company which Muscat argues should be punished by the imposition of liability is where the subsidiary company is undercapitalised.²⁷⁹ However, he accepts firstly that to define capital in this context is a difficult task and then secondly there is the need to define what would constitute inadequate capital. The easy scenario is where the investment by the holding company is hopelessly insufficient to let the subsidiary enjoy an independent self-sustainable existence and condemns it to eventually fail.²⁸⁰ Muscat argues that limited liability should have a price, namely that a company should initially be adequately capitalised, i.e. at incorporation, for the right to enjoy limited liability.²⁸¹ He himself raises a number of questions in respect of adequate financing of a subsidiary company. The questions are: firstly what would constitute adequate capitalisation; secondly whether the financing should only be investment capital or may debt also constitute financing and if so whether there should be a specified debt-equity ratio; thirdly should there be a difference between initial inadequate financing and inadequate financing which arises later in the life of the subsidiary company; fourthly whether there should be a causal connection between the inadequate initial financing and the insolvency and finally the extent of the liability, namely should the holding company be held liable for all the debts of the insolvent subsidiary or only for the difference between the inadequate capital and what it should have provided to the subsidiary.²⁸² A further problem is that of the holding company providing loans to the subsidiary: the status of these loans on insolvency of the subsidiary must be addressed as well. Not only ordinary loans are problematic but also secured loans, where the subsidiary company owns no assets but leases all its equipment from the holding company and lastly where the holding company “milks” the subsidiary of all its profits.²⁸³

Muscat again argues that the current English law is inadequate to address the problem²⁸⁴ and proposes that the holding company should be forced to provide sufficient funding for

²⁷⁹ Muscat *Liability of the Holding Company* 306 – 389.

²⁸⁰ Muscat *Liability of the Holding Company* 312.

²⁸¹ Muscat *Liability of the Holding Company* 313.

²⁸² Muscat *Liability of the Holding Company* 315 – 316.

²⁸³ Muscat *Liability of the Holding Company* 316 – 324.

²⁸⁴ Muscat *Liability of the Holding Company* 325 – 362.

the business needs of the subsidiary company at its incorporation. This funding can be a blend of equity and debt, a reasonable portion of the funding should be treated as risk capital. This risk capital of the holding company, to the extent that it does not consist of equity, should be a subordinated claim at the insolvency of the subsidiary company, and the holding company should be held liable for the debts of its insolvent subsidiary if it inadequately financed the subsidiary.²⁸⁵

Muscat accepts that the most challenging aspect of his proposal is the determination of what adequate financing will be and how should the holding company determine which portion of the funding should be risk financing.²⁸⁶ He argues that it is relative easy to determine the level of start-up capital which is needed since an incorporator would usually look at factors like the start-up capital required, the possible cash flow, the level of funding to ensure the generation of income and the debts which the company may face.²⁸⁷

The difference between risk capital and loans can be determined by various factors which overlap with the proposals by the Cork Committee.²⁸⁸ These factors are the expectation of payment by the holding company, the debt-equity ratio, what the loans are used for, the name for the transaction between the two companies, the terms of the arrangement and the length of repayment, the proportion of equity advances made compared to loans made by the holding company, the history of the subsidiary in respect of the loans it has obtained and the income it has generated, the question whether parties dealing at arm's length would have entered into the loan agreement on the terms and the motives of the parties. The court should then weigh these factors in the light of the facts at hand.²⁸⁹

²⁸⁵ Muscat *Liability of the Holding Company* 363 – 364. The court should have a discretion to determine the extent of the liability.

²⁸⁶ Muscat *Liability of the Holding Company* 365.

²⁸⁷ Muscat *Liability of the Holding Company* 366 – 368.

²⁸⁸ Muscat *Liability of the Holding Company* 369 and see para 1964, 442 of the Cork Report where the Cork Committee stated in this regard that factors to be considered when distinguishing loans and risk capital would be the original debt-equity ratio; the adequacy of the paid-up share capital; the absence of reasonable expectation of payment; the terms on which the advance was made and the length of time for which it has been outstanding; whether outsiders would make such advances; and the motives of the parties.

²⁸⁹ Muscat *Liability of the Holding Company* 369.

The remedy would only be available to deceived creditors²⁹⁰ and involuntary creditors since most creditors could have investigated the capital structure of the subsidiary. Muscat also raises the question whether the adequate capitalisation obligation should be continuous or not and accepts that there is no easy answer. Certainly sufficient initial capital should be provided to allow a chance of survival but if business adversity strikes, it cannot necessarily be expected of the holding company to increase its exposure. On the other hand, if the holding company forces the subsidiary into an expansion drive it should ensure that the subsidiary is continuously sufficiently capitalised.²⁹¹ The extent of the obligation therefore depends upon the particular circumstances.

There must furthermore be a causal connection between the undercapitalisation and the insolvency of the subsidiary company and its subsequent inability to pay its debts, otherwise it would lead to unfairness.²⁹² The extent of the liability should be in the discretion of the court.²⁹³

7.8.3 The integrated economic situation

Muscat accepts that mere economic integration of the companies within the group is not sufficient to attract liability for the holding company. It should be remembered that companies within a group can be vertically or horizontally integrated. Muscat argues that the economic integration should be abusive before liability can be imposed on the holding company.²⁹⁴ He defines abusive economic integration as being “the unitary enterprise, for no functional reasons whatsoever, [...] artificially fragmented into several legal units with the sole aim of insulating the enterprise from potential claims”.²⁹⁵ Although Muscat accepts that *Adams v Cape Industries plc*²⁹⁶ rejected the single economic approach of Lord Denning in the *DHN Food Distributors Ltd v Tower Hamlets*²⁹⁷ decision he refers to the fact that the court of appeal in the *Adams v Cape plc*

²⁹⁰ Creditors who have been fraudulently misled regarding the financial position of the subsidiary

²⁹¹ Muscat *Liability of the Holding Company* 385 – 386.

²⁹² Muscat *Liability of the Holding Company* 388.

²⁹³ Muscat *Liability of the Holding Company* 389.

²⁹⁴ Muscat *Liability of the Holding Company* 399.

²⁹⁵ Muscat *Liability of the Holding Company* 399.

²⁹⁶ Para 6.1 above, [1990] BCLC 479.

²⁹⁷ Para 3.10 above, [1976] 1 WLR 852 (CA)

case recognised that the corporate veil will be ignored where a façade exists which conceals the true state of affairs. Muscat asks whether an abusive economic integration would be such a façade.²⁹⁸ He refers in this regard to the law of the United States and argues ultimately for legislative intervention without, however, providing a detailed proposal.²⁹⁹ He proposes that the holding company should be liable towards tort victims since they are not aware of the deception that the group is an integrated entity and the group liability should be to their advantage.³⁰⁰ Voluntary creditors can, however, only complain if they were deceived.³⁰¹

7.8.4 The group persona situation

The last ground which Muscat argues should be addressed is where the group holds itself out as one entity. Often creditors and the public are confused as to the entity with which they are dealing in a group, on the assumption they know that the entity is part of a group.³⁰² Muscat accepts that the mere fact that a group holds itself publicly out as one entity should not be sufficient for liability. Where, however, there is misrepresentation to the public or creditors, i.e. the individual companies within the group are portrayed as a single enterprise and creditors are misled, there should be liability for the holding company.³⁰³ Liability should here be in the form of substantive consolidation and to avoid unfairness substantive consolidation should be adapted where some creditors specifically relied on the credit of specific subsidiaries.³⁰⁴ He argues that delictual creditors should be able to rely on this ground even though they never relied on the group persona and although the existence of an abusive group persona is merely coincidental. Delictual creditors should benefit by receiving compensation but also “[as] a means of penalising the abuse and deterring such unconscionable conduct.”³⁰⁵

²⁹⁸ Muscat *Liability of the Holding Company* 404.

²⁹⁹ Muscat *Liability of the Holding Company* 413.

³⁰⁰ It is submitted that delictual claims of employees of the subsidiary could be rejected if they are aware that the group operates as a single entity.

³⁰¹ Muscat *Liability of the Holding Company* 414-415.

³⁰² See the *Qintex* case, para 7.1 above and the *BOE* case, para 5.7.3 above.

³⁰³ The distinction between liability due to the misrepresentation of the structure and cases where there is no distinction seems to be tenuous. However, when one looks at the structure of the MTN group (see figure 1, para 1.1) MTN does publicly hold itself out as a single entity. However, this fact probably does not suffice to incur liability based on the group persona situation since there is no misrepresentation.

³⁰⁴ Muscat *Liability of the Holding Company* 435.

³⁰⁵ Muscat *Liability of the holding company* 435.

7.9 Evaluation

It has been shown in this dissertation that the principle of limited liability is suspect when it involves a group of companies. It was shown in chapter two that the principle of limited liability was most likely adopted by the legislature to stimulate investment by natural persons without them having to fear liability should the business venture in which they invested, fail. It was also shown that a group of companies quite often forms a single economic unit but that despite this fact the judiciary does not, as a rule, accept this as a basis to impose liability on a holding company for the obligations of its subsidiary. In chapter five it was shown that the legislature in South Africa also treats a group of companies as one entity in some respects but not in other respects.

The insolvency of a group member is one of the situations where the legislature has not adopted any specific provisions which creditors could use to hold the holding company liable for the debts of its insolvent subsidiary. Reference was made to the provisions of the 1973 Companies Act which may have provided relief to a creditor of an insolvent subsidiary, but with the advent of the new Companies Act this potential remedy appears to have been lost.³⁰⁶ With the exception of the principle of piercing the corporate veil there seems to be no remedy for the creditor of a subsidiary company other than using the principles of agency, which were not discussed in this dissertation since there has not been any successful reliance on these principles in South Africa. It was also shown in the *Adams v Cape plc*³⁰⁷ case that agency is very difficult to prove. In the light of the conservatism of the South African judiciary towards the piercing of the corporate veil this remedy also seems unlikely to succeed. There has been no case law in South Africa where the corporate veil has been pierced between a holding company and a subsidiary to hold the holding company liable for the debts of the insolvent subsidiary company. No case could even be found where this was attempted. Does this therefore mean that the law as it currently stands is insufficient to cover abuses which could take place upon the insolvency of the subsidiary company?

³⁰⁶ See para 7.2.2 above.

³⁰⁷ See para 6.1 above and see also the *Adams v Cape plc* decision 544-546.

Despite the dubious historical foundations for applying the principle of limited liability to company groups, it is a given that the principle was adopted to cater particularly for the situation where the company, in which an investor has invested, fails and goes into insolvency. In such a case the investor would as a general rule not be liable for the debts of the insolvent company. The principle of limited liability is therefore there on the one hand to stimulate risk taking. However, as the court mentioned in the *Philotex (Pty) Ltd v Snyman; Braitex (Pty) Ltd v Snyman*³⁰⁸ the purpose of business is to take risks but that risk-taking must not be excessive.³⁰⁹

Limited liability is a privilege and not an automatic right. It may therefore not be abused and if it is abused, the law provides some remedies in the form of the piercing the corporate veil, although this remedy is rarely granted by a court because of the strict requirements imposed in the interests of greater certainty in South Africa and England, especially.

In the context of the insolvency of a subsidiary company and the possible liability of its holding company the issue surrounding liability of the holding company becomes more complex, especially due to the interests of the creditors of the holding company as well as the minority shareholders, if any.³¹⁰ The position of minority shareholders will not be further considered for, as has already been shown, the interests of shareholders yield to the interests of creditors in cases of liquidation.³¹¹ Furthermore the minority shareholders of a holding company possibly had the opportunity to influence the conduct of the holding company *vis-à-vis* the subsidiary, and by extension the creditors of the subsidiary company. The creditors of the holding company are, however, exposed in those cases where they contracted with the holding company on the basis that the holding company is a separate entity and not due to its group membership. Where the holding company acts

³⁰⁸ *Philotex (Pty) Ltd v Snyman; Braitex (Pty) Ltd v Snyman* 1998 2 SA 138 (SCA).

³⁰⁹ "Participation in business necessarily involves taking entrepreneurial risks but s 424 only penalises the subjection of third parties to risk where (apart from the case of fraudulent trading) it is grossly unreasonable, 146G."

³¹⁰ See generally the comments of the Cork Committee as well as the cases referred to in this chapter from the United States of America, para 7.4 above.

³¹¹ See para 7.2.1 above.

recklessly, fraudulently or otherwise prejudicially towards the creditors of the subsidiary company, the creditors of the subsidiary company may want to hold the holding company liable for the debts of the insolvent subsidiary. This may however lead to a potential conflict of interests between the two sets of creditors. If the holding company is liable for the debts of the insolvent subsidiary, or has to make a contribution or there is a pooling of assets this will reduce the assets, which are exclusively available for the creditors of the holding company.³¹² Should any imposition of liability on the holding company specifically have to take into account the interests of the innocent creditors of the holding company or should the court be given a broad discretion based on fairness? The court in *Chemical Bank New York Trust Company v Kheel* said in this regard:

“[E]quity is not helpless to reach a rough approximation of justice to some rather than deny any to all.”³¹³

It is clear from the cases mentioned in this chapter that the position of the creditors of the holding company is taken into consideration before an order is made in respect of liability for the debts of the insolvent subsidiary company. The only manner in which to determine which creditors deserve more protection is by means of policy considerations. But where does the balance between these policy considerations lie? Equally strong arguments could be made out in respect of the protection of each set of creditors, especially where all of them were innocent participants in the activities of the subsidiary and holding companies. Is there therefore a way to protect each set of creditors and simultaneously to satisfy their competing claims?

On the assumption that changes to the law have to be made to impose liability on a holding company, the question arises as to what this proposal for change should contain. It is submitted that the most viable options are the provisions of the New Zealand Companies Act dealing with liability in groups, namely pooling orders and contribution orders,³¹⁴ the substantive consolidation orders which the courts in the United States may

³¹² See generally the Cork Committee Report, *Re Dalhoff and King Holdings Ltd* [1991] 2 NZLR 296 and *In Re Owens Corning* 419 F. 3d 195 (3rd Circuit Delaware 2005).

³¹³ *Chemical Bank New York Trust Company v Kheel* 369 F.2d 845 (1966) 847.

³¹⁴ See para 7.3 above.

order,³¹⁵ the provisions of the Australian Corporations Act dealing with holding company liability³¹⁶ and an adapted version of section 424 of the 1973 Companies Act, in the light of the underlying principles of German law, which recognise the single economic unit constituted by a group of companies.

The problems with the New Zealand and United States provisions have already been discussed although the courts in the *Dalhoff and King Holdings* and *Owens Corning* cases managed to restrict the application of liability for the holding company to prevent prejudice, especially for the creditors of the holding company. The possibilities of these two systems are therefore plausible options to consider, since they have not led to unrestricted liability for the holding company and its creditors have in general been well protected.

The provisions of the Australian Corporations Act and an adapted section 424 provision *prima facie* seem less intrusive and therefore more protective of the interests of the creditors of the holding company. On further examination, however, it is clear that the potential for prejudice to the creditors of the holding company is just as real under these options as it is under the New Zealand and United States options. Holding the holding company liable for the debts of its insolvent subsidiary inevitably reduces the asset base of the holding company which creates the possibility that there may not be sufficient assets to satisfy the claims of the creditors of the holding company.

There is one provision in South African law where the creditors of a non-insolvent debtor are prejudiced and potential preference is given to the creditors of the actual insolvent debtors. This provision is found in the Insolvency Act.³¹⁷ The Insolvency Act provides that where two parties are married out of community of property and the estate of one spouse is sequestrated, the assets of the other party vest in the trustee of the insolvent

³¹⁵ See para 7.4 above.

³¹⁶ See para 7.5.5 above.

³¹⁷ Insolvency Act 24 of 1936.

spouse, unless the solvent spouse can show that the assets are in fact the assets of that solvent spouse.³¹⁸

The purpose of this provision in the Insolvency Act in respect of the assets of the solvent spouse is to prevent collusion between spouses.³¹⁹ In terms of the common law the trustee had no power to attach the property of the solvent spouse and he had to prove that there was a collusive disposition between the spouses for the purpose of defrauding the creditors of the insolvent spouse, where he suspected that the insolvent spouse transferred assets to the solvent spouse.³²⁰ The trustee of the estate of the insolvent spouse has to release certain property of the solvent spouse. This includes property which belonged to that spouse before marriage,³²¹ property acquired under an ante-nuptial contract,³²² property which the solvent spouse acquired with valid title against the creditors of the insolvent spouse during the marriage³²³ and property which was obtained with the proceeds of the previously mentioned property.³²⁴ The solvent spouse bears the onus to prove that the property falls within the previously mentioned categories and should be released to him.³²⁵

The most interesting effect of the provision in respect of the property of the solvent spouse is the one which determines the effect of that spouse's failure to prove that certain assets are her property.³²⁶ Section 21(5) of the Insolvency Act provides that:

“Subject to any order [releasing property] made under subsection (4) any property of the solvent spouse realized by the trustee shall bear a proportionate share of the costs of the sequestration as if it were property of the insolvent estate but the separate creditors for value of the solvent spouse having claims which could have been proved against the estate of that spouse if it had been the estate under sequestration, shall be entitled to prove their claims against the estate of the insolvent spouse in the same manner and, except as in this Act is otherwise provided, shall have the same rights and remedies and be subject to the same obligations as if they were creditors of the

³¹⁸ S 21 of the Insolvency Act 24 of 1936.

³¹⁹ *Maudsley's Trustees v Maudsley* 1940 TPD 399, *De Villiers NO v Delta Cables (Pty) Ltd* 1992 1 SA 9 (A).

³²⁰ *Conrad v Conrad's Trustee* 1930 NLR 100.

³²¹ S 21(1)(a) of the Insolvency Act.

³²² S 21(1)(b).

³²³ S 21(1)(c).

³²⁴ S 21(1)(e).

³²⁵ *Maudsley's Trustees v Maudsley* 1940 WLD 166.

³²⁶ S 21(5) read with s 21(3) and 21(4).

insolvent estate; and the creditors who have so proved claims shall be entitled to share in the proceeds of the property so realized according to their legal priorities *inter se* and in priority to the separate creditors of the insolvent estate, but shall not be entitled to share in the separate assets of the insolvent estate.”

This provision *prima facie* appears to be nonsensical. It in essence provides that if the solvent spouse cannot prove that assets belong to her, the trustee of the insolvent spouse may realise these assets. The proceeds of the assets are however for the satisfaction of the claims of the creditors of the solvent spouse. If the solvent spouse could not prove that the assets belong to her, why should her creditors then be paid from these assets?³²⁷ The provision still exists despite this contradiction. What it does however provide is a recognition that dispositions between related parties are realities and that they are very difficult to prove, which is detrimental to the creditors of an insolvent person. The shifting of the onus of proof to the solvent spouse to prove that the assets belong to her is an attempt to safeguard the interests of the creditors of the insolvent party, which relieves them from the burden of proving that there was a collusive disposition.

There are therefore provisions in South African law, although inelegantly and contradictorily drafted, which attempt to reconcile the interests of the competing creditors of spouses. The question is whether this could be a workable solution in the context of a group of companies. As mentioned before the aim of section 21 of the Insolvency Act is to prevent collusive dealings between spouses and the difficulty facing creditors of the insolvent spouse to prove such collusive dealings. It is submitted that the same difficulties would not necessarily be present in the context of a company group. In the first place the subsidiary may be obviously undercapitalised and own very few assets which it can dispose of. Secondly profits would have been declared and paid to the shareholders. A paper trail of asset movement would make collusion more difficult to conceal in a group situation than between spouses. A rebuttable presumption or a provision shifting the onus of proof could however be helpful.³²⁸

³²⁷ See further Evans “A critical analysis of the section 21 of the Insolvency Act 24 of 1936” 1997 (60) *THRHR* 71; Joubert “Artikel 21 van die Insolvensiewet: Tyd vir ‘n nuwe benadering” 1992 *TSAR* 699.

³²⁸ See the proposals contained in para 6.8 above.

Milo is of the opinion that any liability will have to be imposed by means of legislation on the holding company, since the piercing of the corporate veil doctrine, agency argument and partnership argument are too vague or uncertain.³²⁹ Milo suggests that any legislation should consider an appropriate adaptation of the German-law provisions although he does not suggest how this should be done.³³⁰ Milo does suggest that there should be a presumption that the holding company ignored or did not respect the separate identity of the subsidiary. This presumption rests on the basis that the principle of limited liability is not necessarily desirable and can therefore be ignored as a point of departure. If the holding company succeeds in discharging this presumption, the *Salomon* principle will apply.³³¹ The justification for the presumption which Milo advocates corresponds to the arguments above,³³² namely that limited liability is a historical accident in respect of company groups and that the economic justification of the principle is not necessarily convincing in respect of company groups.³³³

It is submitted that Milo is correct to suggest that the provisions in the German law are theoretically sound and could serve as a guide to legislative reform regarding liability of holding companies in South Africa. However, it has been shown above that the practical implementation of the provisions of the German *Aktiengesetz* has caused difficulty. It has been shown that the problems regarding *de facto* groups are the difficulties to distinguish directives from the holding company to the subsidiary from the directives of the directors of the subsidiary itself, the business judgment rule available as a defence to the holding company and the calculation of the damages which flowed from the harmful directives of the holding company.³³⁴ The treatment of qualified factual groups, after the *Tri-hotel* decision,³³⁵ would appear to lean towards delictual liability which is close to the Dutch model of liability.³³⁶

³²⁹ Milo "The Liability of a Holding Company for the Debts of its Insolvent Subsidiary: Is *Salomon* still alive and well?" (1998) 115 *SALJ* 318.

³³⁰ Milo *Salomon* 344.

³³¹ Milo *Salomon* 344.

³³² See, for example, paras 2.2.2, 2.3 and ch 3 above.

³³³ Milo *Salomon* 340-341 with reference to Blumberg above.

³³⁴ See para 4.5.1 above.

³³⁵ See para 4.5.2 above.

³³⁶ See para 7.6 above.

To conclude this evaluation it appears that the best option for legislative reform is a proposal based on the New Zealand, and therefore the Australian law regarding pooling orders, and United States law but also including a provision similar to section 424 of the 1973 Act. The provisions for reform must then however bear in mind the practical problems as well as the policy considerations in respect of the creditors of the holding company and ensure that liability does not result in an inequitable result where some creditors are disadvantaged.

7.10 Proposal

It is submitted that an appropriate statutory provision could read as follows:

“(1)(a) When it appears in a winding-up or otherwise that any business of a company was carried on recklessly or with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose, the Court may, on the application of the the liquidator any creditor or shareholder of the company, declare that a company which is or was a related company of the company and which knows or knew that the company was carrying on its business in the manner aforesaid, shall be responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company as the Court may direct.

(b) To the extent that the Court so orders, upon the application of the liquidator, a creditor or a shareholder of the company being wound-up, and subject to such terms and conditions as the Court may impose, a company that is, or has been, related to the company being wound-up must pay to the liquidator the whole or part of any or all of the claims made in the winding-up subject to subsection (3);

(c) Where two or more related companies are in winding-up proceedings, the winding-up in respect of each company must proceed together, subject to subsection (4) as if they were one company, to the extent that the Court so orders, upon the application of the liquidator, creditor or shareholder of any such company, and subject to such terms and conditions as the Court may impose.

(2) The Court may make such other order or give such directions to facilitate giving effect to an order under subsection (1)(b) and (1)(c) as it thinks fit.

(3) In deciding whether to make an order under subsection (1)(b), the Court must have regard to the following matters:

(a) The extent to which the related company took part in the management of the company in liquidation;

(b) The conduct of the related company towards the creditors of the company in liquidation;

- (c) The extent to which the circumstances that gave rise to the liquidation of the company are attributable to the actions of the related company;
 - (d) The interests of the creditors of the related party;
 - (d) Such other matters as the Court thinks fit.
- (4) In deciding whether to make an order under subsection (1)(c), the Court must have regard to the following matters:
- (a) The extent to which any of the companies took part in the management of any of the other companies;
 - (b) The conduct of any of the companies towards the creditors of any of the other companies;
 - (c) The extent to which the circumstances that gave rise to the liquidation of any of the companies are attributable to the actions of any of the other companies;
 - (d) The extent to which the businesses of the companies have been combined;
 - (e) Such other matters as the Court thinks fit.”

The proposal in subsection (1)(a) contains elements of section 424(1) of the 1973 Act, the Australian Corporations Act, the substantive consolidation powers of the United States’ courts as well as the spirit of the German *Aktiengesetz*. The spirit of the German legislation is reflected in the acknowledgement that a group of companies forms one entity in many cases, that abuse can take place and that the law should recognise this fact. The contribution and pooling provisions under subsection 1(b)-4 are based on the corresponding provisions of the New Zealand Act.³³⁷

The proposal in aggregate provides for three forms of liability, namely full liability where there is reckless or fraudulent conduct and which liability is not restricted to winding-up proceedings but can also be instituted at any time, full or partial contributions where the conduct of the holding or other related company was not necessarily reckless or fraudulent but could still have been abusive or a disguised single entity and therefore a façade, and thirdly pooling orders where the companies in a group are in winding-up and certain abusive practices may have been present or the group was a façade for a single entity.

³³⁷ See para 7.3 above.

It is submitted that the provisions are not unduly onerous on holding companies or groups since there is no blanket liability. Furthermore the proposal is predictable since investors will be aware what is expected when they create groups and what the required conduct of the holding company must be, as well as the factors which would be most relevant to a court. In essence the principle of limited liability has been maintained despite the doubt which has been expressed about its historical applicability to groups as well as the less than convincing economic arguments in favour of limited liability, which have been shown to be more applicable to natural persons as investors and therefore shareholders.³³⁸

There is also no rebuttable presumption as in the case of delictual liability. The reason for this is that, despite the historical accident of limited liability in respect of groups, recognition is given to the purpose of limited liability as being to prevent liability for investors, since one of the aims of the principle is to stimulate risk. Protection is, however, given to creditors by means of the provisions, which should punish excessive risk taking. The most extreme intrusion on limited liability is the possibility that the holding company may be held liable even if the subsidiary is not in liquidation. This corresponds with the section 424(1) of the 1973 Act and is therefore not entirely new. The evidentiary burden on a litigant will still be difficult. He will have to prove recklessness or fraud and then that the holding company knew about the conduct. The “party to” requirement has been removed to avoid the evidentiary burden which it could create.³³⁹ Knowledge of the holding company could be ascertained on the facts without having a presumption and the existing directing minds doctrine could be helpful.³⁴⁰ Putting “independent” directors on the board of the subsidiary company who are not on the board of the holding company will not assist the holding company to avoid liability if it is shown that the independent directors are in fact not independent at all. The holding company will therefore have to show that the operations were at arms’ length to avoid liability.

³³⁸ See paras 2.2.2, 2.3, 2.5 and 2.6 above.

³³⁹ See para 7.2.2 above.

³⁴⁰ See para 7.2.2 and the cases cited there above.

The contribution and pooling provisions under subsection 1(b)-4 are aimed at achieving an equitable result for creditors, since the aim of winding-up is to bring about a fair distribution for creditors, in circumstances where one or more companies in the group conducted themselves in such a manner to the creditors which may have caused them to believe that they are dealing with one entity. Ultimately the court has a discretion whether to grant any of the orders and to issue supplementary directives where pooling orders are granted. The court will have to look at the interests of all creditors of all the entities within the group and also has the power to consider any other relevant factors, for example the interests of shareholders in the related entities. Where the court therefore is of the opinion that there may not have been recklessness or fraud but the conduct was unconscionable, gravely improper or wrongful, it has the power, on application, to employ the “lesser” remedies of pooling or contribution orders.

In respect of the question of the claims which group members may have against an insolvent member the court has the power in terms of the voidable preference provisions of the Insolvency Act³⁴¹ to deny claims in cases of collusion which would more than likely usually be present where payments were made close to liquidation. In respect of more *bona fide* claims the danger exists that the holding company undercapitalised the subsidiary company and funded it, virtually, by means of loans only. In this case subsection 2 should provide a wide enough power to convert such a loan into investment capital by considering the arguments of Muscat³⁴² and the Cork Committee or subordinating such loans to below the concurrent creditors.

7.11 Conclusion

It has been shown that the doctrine of limited liability was not necessarily conceived for the group of companies situation and was probably more of a historical accident in that context. Also, once economic arguments are introduced, the doctrine seems to lack

³⁴¹ Ss 26, 29, 30 and 31 of Act 24 of 1936 and see para 7.2.1 above.

³⁴² See para 7.8.2 and para 1964, 442 of the Cork Committee Report where the committee provides the following guidelines to determine whether funding by a holding company to its subsidiary constitutes a loan or as capital. Factors to be considered would be the original debt-equity ratio; the adequacy of the paid-up share capital; the absence of reasonable expectation of payment; the terms on which the advance was made and the length of time for which it has been outstanding; whether outsiders would make such advances; and the motives of the parties.

justification in respect of groups. This is even more so in cases of delictual liability as was shown above.³⁴³ Despite this and the fact that many groups form single economic units, the law still, as a rule, does not treat a group of companies as one entity.

The South African law in various statutes, including the 1973 and the new Companies Acts, provides for groups in different ways without much consistency.³⁴⁴ Despite exceptions to limited liability, including the piercing of the corporate veil principle, the law still does not currently make adequate provision for abuse within groups due to the vagueness and uncertainty of the piercing of the corporate veil doctrine. Legislative reform is therefore necessary. The German *Aktiengesetz* is a legislative attempt which has partially succeeded although it has its problems and does not address all groups. It, however, recognises the realities of external relationships in the context of company groups. Other jurisdictions have begun addressing the external realities of company groups, most notably Australia and New Zealand in cases of insolvency law. In cases of delictual liability the law in South Africa, England and Australia still do not deal with abuse as flexibly as in the United States of America. The judiciary in the United States has also done significant work in addressing the external realities of groups although it still appears to be in a haphazard manner. There are therefore strong arguments for the South African legislature to implement reforms on the lines of the proposals suggested above.

³⁴³ See para 6.4 and 6.5 above.

³⁴⁴ See para 5.8 above.

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